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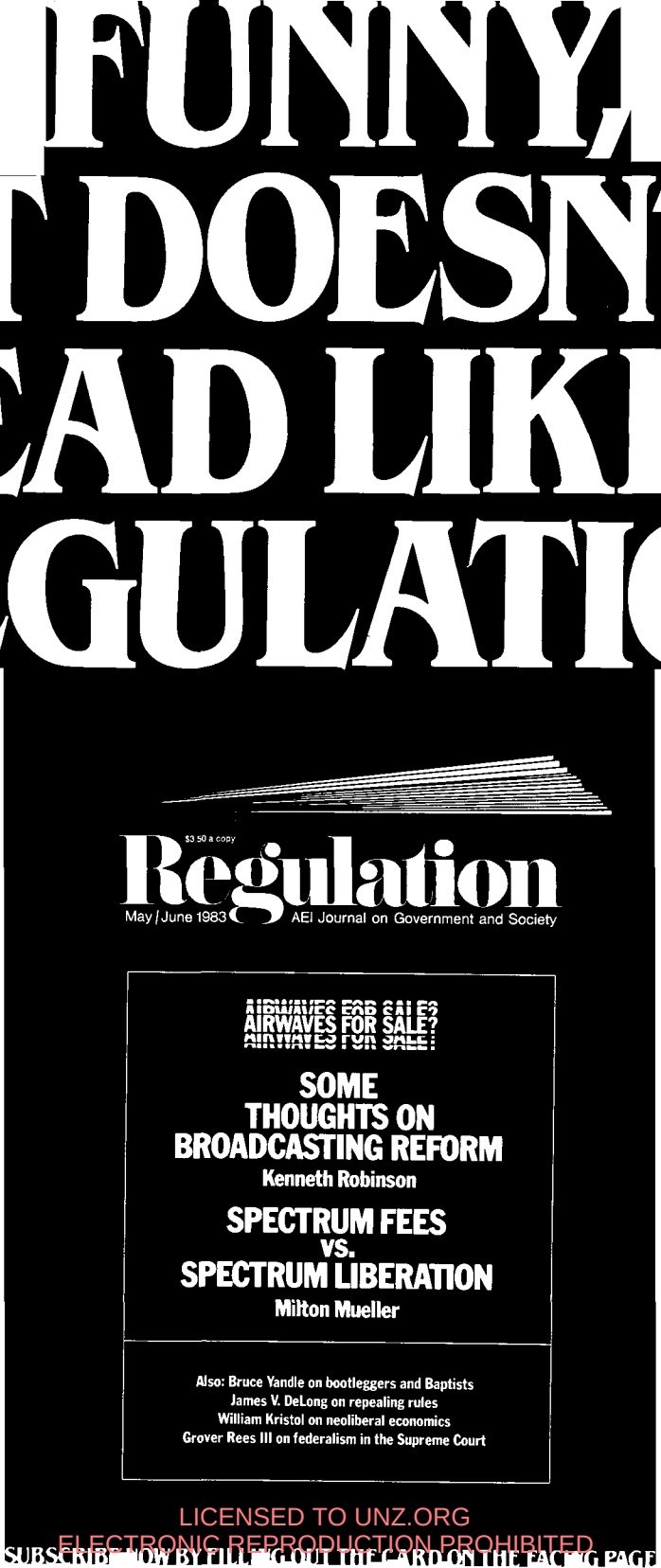
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Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.

Oil Divorcement: Refining the Issues

TO THE EDITOR:

The oil divorcement legislation now pending in Congress would prohibit major oil refiners from operating gasoline stations. John Barron and John Umbeck's report on their study of this issue ("A Dubious Bill of Divorcement: The Case of Oil Refiners and Gas Stations," *Regulation*, January/February 1983), which was funded by the Atlantic Richfield Company, contributes little to enlightened debate on the subject. As chief sponsor of the proposal in the House of Representatives, I would like to point out some of the article's errors and omissions.

Testifying before the Pennsylvania state legislature in March, Umbeck acknowledged that gasoline prices in Maryland remain among the lowest in the nation—even today, four years after the state's comprehensive divorcement law was implemented. In fact, anyone who travels through the mid-Atlantic region can see that gasoline prices in Maryland are highly competitive with those in neighboring states.

Although Barron and Umbeck say they designed their comparison of Maryland prices before and after divorcement so as to avoid the pitfalls of previous studies, they fell into the most obvious trap of all. The Maryland divorcement law went into effect in 1979, which was also the last year that gasoline was subject to federal price controls and supply allocations. During the period of federal regulation, refiners had repeatedly petitioned for permission to raise prices in their company-operated outlets. Meanwhile, independent dealers had been forced to operate under arbitrary limits on their profit margins. After decontrol, marketers of all classes raised prices in search of compensation for half a decade of price and supply regulations.

I cannot conceive how these two scholars could study Maryland gas prices for so long without taking into account the effects of federal regulations. They have made the same mistake as the authors of the 1979 Department of Energy study that projected future gasoline prices based on the assumption that government-mandated price differentials would remain in place forever.

Barron and Umbeck make some misleading statements that further mar their argument. First, they

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John Barron and John Umbeck on oil refiners and gas stations
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note that the number of company-run service stations remained relatively stable between 1973 and 1979 (the only period for which we have good data). That might seem to indicate that the company-operated stations were not expanding in a predatory way. What they fail to mention is that the volume of these stations did not remain stable. The number of gallons sold in company-run outlets more than doubled during those years. Data provided by the American Petroleum Institute show that the refiner-run stations increased their market share by roughly 10 percent.

Second, it is a cheap shot for the authors to suggest that divorcement would ban "superpumper" stations. Nothing in my divorcement proposal would prevent the operation of high-volume, self-service stations offering the lowest gasoline prices. Indeed, there are in Maryland today a number of such stations operated by independent, branded dealers. Several nonrefiners operate large chains of these stations across the United States.

The authors make much of predatory pricing but do not even mention the abundant evidence of predatory *costing*, which is the primary issue. Through lease terms and supply franchise agreements, refiners can unilaterally control rents, the prices and supplies of products, credit policies, hours of operation, and many other elements crucial to a gasoline dealer's business. Why should a refiner sell gasoline at a loss when it can force dealers' prices up beyond competitive levels?

I am hard-pressed to think of any other industry where one business can exercise such complete control over another. Perhaps Barron and Umbeck should do another study to find out how much of the price increase they observed after decontrol was due to new terms in leases or supply contracts forced on independent gasoline dealers by their suppliers/landlords, the oil companies. I doubt that Atlantic Richfield would be as willing to fund that study as they were the first.

Berkley Bedell,
U.S. House of Representatives

TO THE EDITOR:

As Barron and Umbeck note, there is little doubt that divorcement legislation is anticompetitive and costly. While agreeing with their overall conclusion, however, I have a few differences.

Barron and Umbeck ascribe the decline in the number of franchised stations to the drop in the demand for gasoline and for the services offered by the full-line service stations. Gasoline consumption has indeed fallen from its 1978 peak (down 12 percent by 1982), but it

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has leveled off in the past three years. The principal reason why there are fewer franchised dealers is that the economics of marketing has changed. Before the price increases of the 1970s, the refiners' marketing strategies called on them to sell at many low-volume locations. Now, to maintain a reasonable overall rate of return, station costs must be spread over more gallons, which means selling more gas at each of fewer stations. Traditionally, franchised dealers have operated low-volume stations, while company-run operations have been built on the principle of high volume, no-frills service.

Divorcement is costly. The Metzenbaum-Thurmond bill (S. 40) would force the sixteen largest refiners to divest their company-operated stations. The latest available DOE data (as of September 1981) show that fifteen of these refiners sold gasoline at their own stations for an average of six cents less than their franchised dealers did. Had a divorcement law been in effect that year driving prices up to the franchised dealers' level, consumers would have paid about $330 million more at the pump.

Barron and Umbeck want to show that franchised dealers would prosper under divorcement, but I am not so sure that they would. For refiners that were running their own stations, a forced switch to franchised dealerships would mean increased marketing costs. Higher retail prices, then, would come from the higher cost of doing business, not from profits. Perhaps some of the higher prices would result in profits for refiners or dealers, but that is highly speculative. In any event, gasoline consumers would lose because they would pay higher prices for a less desirable mix of services. Would anyone win?

Leonard L. Coburn,
Department of Energy

TO THE EDITOR:

Barron and Umbeck make a compelling case that divorcement legislation is anticompetitive. They systematically show how the Maryland law cost consumers several cents per gallon in affected markets, amounting to roughly $15 million per year, while benefiting some franchised dealers. Consumers and the legislators who represent them should ask themselves if they really favor taking small sums from a great many people to provide special benefits for a few.

Studies by Philip Sorensen of Florida State University and Lawrence Lamont and Charles Phillips of Washington and Lee University have confirmed Barron and Umbeck's findings, and also noted other benefits that refiner operation provides for consumers, such as keeping stations open for longer hours. Similarly, a January 1981 Department of Energy study suggested that divorcement of gas stations would cost consumers millions of dollars.

Although divorcement proposals are still being considered in some states, the Maryland law appears to be an anachronism today. First, most states that have considered divorcement legislation have ended by rejecting it. Second, since gasoline was decontrolled in January 1981, service to motorists has greatly improved and some of the franchised dealers' complaints have been rendered moot. The interests of consumers will be best served if the Maryland divorcement law is simply consigned to the textbooks as an example of special interest legislation.

Thomas F. Hogarty,
American Petroleum Institute

JOHN UMBECK responds:

Representative Bedell thinks he finds four serious errors in our article. He claims that Maryland gas prices are among the lowest on the East Coast, that we ignored the effect of federal regulation on retail gas prices, that the major oil companies may have increased the volumes of their own stations in a predatory way, and that the real reason for the price increases we observed was predatory costing. I would argue that it is Bedell's arguments that are misleading on each point.

First, Bedell quotes my testimony before the Pennsylvania legislature acknowledging that Maryland's gas prices were among the lowest in the nation. But he fails to mention that this fact is irrelevant to the divorcement issue. Suppose an Olympic runner can beat any and all competitors by running a mile in three-and-a-half minutes, but falls and breaks his leg. After recovering, he takes longer to run the mile but is still faster than his competition. Bedell would claim that the fall did not hurt him because he is still faster than other runners. A scientist would point out that the fall slowed the runner's speed. Similarly, even if Maryland's gas prices were the lowest in the country, it would prove nothing about the effects of divorcement. The real question would still be whether divorcement had made prices higher than they would have been otherwise.

Furthermore, it turns out that the seemingly low gas prices in Maryland are more illusory than real. Recent evidence submitted to the Pennsylvania Governor's Energy Council shows that the interstate comparison in question was based on retail pump prices that included a wide variety of state taxes. When these taxes are deducted, Maryland's retail prices in fact appear to be among the highest in the eastern region. More relevant for our purposes, the difference has increased since the state's divorcement law was implemented.

Bedell also accuses us of ignoring federal price regulation. We did not ignore it; we simply found that it had no effect on the divorcement issue. During the period we studied, the federal government set ceilings on the markup over wholesale costs that franchisers and company-operated stations could charge. In addition, the regulations discriminated against company-operated stations by allowing them a smaller markup on average than franchised outlets. For most of the period, however, these constraints were not binding. Until the Iranian crisis in spring 1979, retail gas prices were

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well below their legal maximum. Legally both franchisees and refiners could have raised their prices if they had wanted, but competition restrained them. By May 1979, most stations had run up against their legal price limits, where they remained for about a year. When we tested the effects of these regulations on relative prices in Maryland, we dropped from our regression analysis those months in which prices were at their ceiling. Eliminating them did not significantly alter any of our results.

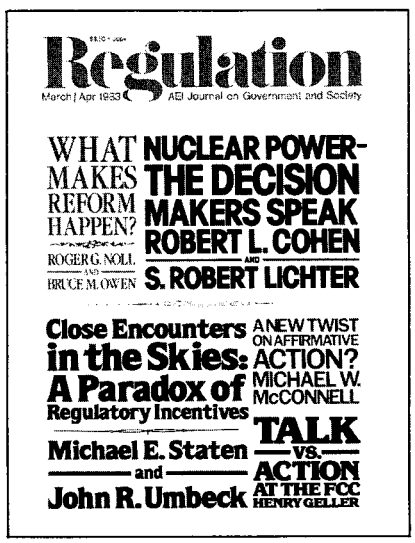
Bedell is correct in pointing out that while the number of company-operated stations has not grown, their share of the retail market has gone up because the total volume per station has risen. But Bedell does not mention the fact that the franchised dealers who stayed in business during this period also enjoyed significant increases in volume. Since 1970, company-operated stations have increased their market share by an average of slightly more than 1 percent a year, and they account for about 18 percent of the total retail gasoline market today. At this rate it will take the refiners eighty-two more years before they succeed in monopolizing the market. Given that the refiners could terminate most of the franchisees in short order simply by not renewing their three-year leases, one must wonder why they are taking the long way around, especially since it will mean eighty-two more years of low prices for consumers. The divorcement bill that Representative Bedell proposes would see to it that these low prices come to an end much sooner—but it would all be for the consumer's own good, of course.

Finally, Bedell suggests that the real problem is not predatory pricing but predatory costing. He says we ignore "abundant evidence" that supports this contention. To date we have seen no such evidence. Some dealers faced with rent increases have accused refiners of predation recently, but the figures they have offered, to the best of our knowledge, have never been tested for bias in sampling or for statistical significance. A recent pilot study revealed no evidence of predatory costing, and indeed suggested that the rent increases observed recently are nothing more than inflation adjustments on leases whose terms had been fixed several years earlier. If Bedell has good statistical evidence of predation he should make it public so that the rest of us can evaluate it.

The Roots of Reform

TO THE EDITOR:

Roger G. Noll and Bruce M. Owen ("What Makes Reform Happen?" *Regulation*, March/April 1983) are rightly optimistic about the prospects for regulatory reform in those policy areas where suppressed market forces are ready to take over from regulators. The generality with which they frame their argument, however, is misleading. It applies mainly to those areas where the problem regulation was intended to solve resulted from supposed market failures or imperfections, which have now presumably been either mitigated by changing technology or reevaluated through the use of more insightful economic analysis.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WHAT MAKES REFORM HAPPEN?
ROGER G. NOLL AND BRUCE M. OWEN
NUCLEAR POWER-THE DECISION MAKERS SPEAK
ROBERT L. COHEN AND S. ROBERT LICHTER
Close Encounters in the Skies: A Paradox of Regulatory Incentives
Michael E. Staten and John R. Umbeck
A NEW TWIST ON AFFIRMATIVE ACTION?
MICHAEL W. McCONNELL
TALK VS. ACTION AT THE FCC
HENRY GELLER

Many targets of old-style economic regulation, such as transportation and communication, fall into this category. Many targets of the new social or protective regulation, however, do not. In such cases as food safety and hazardous waste management, the pre-regulatory problem can be blamed more on failures or imperfections in the process of litigation than on the market. Unlike the operation of markets, the construction of an efficient and equitable litigation system requires a good deal of human artifice. No naturally "good" system is sequestered underground ready to spring into action if we abolish the food safety laws or—for all its defects—the Superfund arrangement.

Another important reason why loosening the strictures of protective regulation will prove harder than deregulating the economic domain is the higher burden of moral justification that encumbers it. To be sure, removing government restraints on competition can be painful to affected producers, but that is a mild offense indeed compared to the seeming abandonment of the potential victims of corporate negligence and other, more calculated abuses.

The particular prescriptions for regulatory reform that Noll and Owen advance are to "beef up the corps of analysts who keep their sights trained on the impact of regulatory policy" and to "keep the regulatory process accessible at low cost to a variety of interests" who will "raise questions about the subtle ways in which regulatory rules may serve narrow self-interest," and who will subject policy making to the "sunshine of public scrutiny." The first is as applicable to protective regulation as it is to economic regulation, but the second certainly is not.

Just what "variety of interests" do Noll and Owen have in mind? The social groups with the most stake in raising these kinds of questions about self-interest are producers whose compliance costs (actual or expected) are higher than those of their competitors. Although some of these producers might inspire occasional widespread sympathy, as in the case of the small inventor who is kept out of a market by excessive and protectionist safety standards, it is hard to see what interveners would come to the defense of these producers on a regular basis. One can hardly expect the "public interest" groups to do so when these groups' reputations depend in large part on opposing lower health and safety standards and when it is these very groups that helped create the regulatory machinery in the first place. Conceivably the affected producers could ally with each other, but the heterogeneity of both their economic niches and their targets for reform would make it unlikely that they could do much more than join general small business groups.

In the end, we must look to that beefed-up corps of analysts sought by Noll and Owen, and to the political power of the government units to which they are attached. Such units are a poor substitute for weighty and resourceful economic or ideological interests, but they are probably all we have.

Eugene Bardach,
University of California
at Berkeley

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Perspectives
on current developments

How to Turn Grandfather Drugs into Orphans

Not too long ago Ralph Nader's Health Research Group brought out a book called *Pills That Don't Work*. The work listed "over 600 prescription drugs that have not been proved effective and yet are still on the market." It blamed this seeming health scandal on "governmental inefficiency, lethargy and timidity, orchestrated by heavy pressure from drug companies. . . ." *Pills That Don't Work* became a paperback bestseller, and the same Nader group went on to prepare a companion volume, scheduled for release this fall, on "ineffective" over-the-counter (as opposed to prescription) drugs. That book, too, indicts the Food and Drug Administration for allowing thousands of apparently worthless preparations to remain on the market.

Usually muckraking books precede, rather than follow, the reform efforts they advocate. Both of these literary efforts, however, arrived after years of litigation by "public interest" lawyers had secured court orders forcing the FDA to act on the issue, and indeed after the agency had completed much of the action required. As one might expect, therefore, the full story is rather more complicated than it may seem. A suitable question to ask might be whether the Nader campaign to review the efficacy of older drugs has succeeded in proving its own efficacy or even safety. If not, the book might better be called *Regulations That Don't Work*.

Before 1962 federal law required simply that drugs be "generally recognized as safe." The Kefauver amendments that Congress adopted in that year added a separate requirement that they be effective as well. Specifically, the amendments required that the FDA find "substantial evidence" of a drug's effectiveness before approving it. In the agency's actual practice, as the director of FDA's Bureau of Drugs conceded in rather candid congressional testimony in 1980, "the amount of evidence needed to support the effectiveness of a drug is closer to the legal standard of 'beyond a reasonable doubt.' "

As readers of these pages well know, the Kefauver rules led the FDA to demand more and more elaborate testing of the effectiveness of a new drug before approving it for marketing. Proving efficacy "beyond a reasonable doubt" has turned out to be quite a challenge, since skeptics can usually find some basis or other for questioning the conclusiveness of clinical trials. (Proving inefficacy would be at least as difficult, for that matter, which must make the FDA glad that it need sustain no such burden of proof.) With large-scale clinical trials some patients will inevitably drop out in a mobile society, so that it is hard to ensure perfect control; on the other hand, small patient samples, which may be the only option in the case of drugs for rare conditions, have less statistical reliability. By the mid-1970s, the FDA's testing standards had become the most exacting in the world, and the average cost of testing a new drug had soared to $50 million. After this preliminary testing, which goes on for many years, FDA officials can demand further clarification and substantiation of the studies included in the drug's marketing application, which means that approval is delayed by an average of three or four more years. These and other problems have contributed to the rise to prominence of the "orphan drugs," new drugs whose commercial value is not worth the cost of the required testing. (See Louis Lasagna, "Who Will Adopt the Orphan Drugs?" *Regulation*, November/December 1979.)

Much less publicized, until recently, was the problem of what to do with the many prescription and over-the-counter drugs that were already on the market before 1962. Drugs first sold before 1938 were clearly "grandfathered," but the FDA was able to persuade federal courts

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that the efficacy requirement should apply to all drugs approved between 1938 and 1962. Would the effectiveness of these drugs also have to be documented using the same involved research methods as new drugs, or should they continue to enjoy some sort of intermediate grandfather status, subject to review in cases where there was evidence of inefficacy?

The FDA took its first major step toward applying the Kefauver standards to these older drugs in the mid-1960s, when it asked the National Academy of Sciences to organize panels of medical researchers to review the effectiveness of all prescription drugs approved before 1962. These reports, which were substantially completed by 1968, covered some 3,700 drug formulations with (since many products had multiple uses) a total of more than 16,000 separate claims of efficacy. The NAS panels judged that only 7 percent of these drugs were "ineffective" for all claims—meaning that, in the panel's opinion, no amount of testing would ever substantiate the therapeutic claims made for the drug. Most claims were rated either "possibly" or "probably" effective, which meant basically that the claims had not yet been substantiated by the most rigorous testing standards, and 20 percent of the claims were considered unqualifiedly "effective." Quite often, however, this rating reflected the panel members' personal experiences or beliefs, rather than the availability of unusually well-controlled studies—on the implicit view that certain preparations, such as most antibiotics, were so manifestly effective that there would be no point in putting them through the paces. Although the NAS conceded that its reviewers had not applied consistent standards in assigning their ratings, the FDA was content to accept the unqualified "effective" ratings.

That still left a huge residuum of possibles and probables to be dealt with. In 1970, fatefully, the FDA issued regulations decreeing that all drug claims in these categories would eventually have to undergo the full testing requirement. It did not contemplate forcing the manufacturers to do so all at once, however, and for several good reasons. First, clinical research is a scarce resource, and if manufacturers had to commission a great many studies at the same time they would cut massively into the time and personnel available for other valuable work ranging from epidemiology to research on new drugs. (Research efforts spread out over many years would also compete for these resources, but less disruptively.) Second, many of the products no longer generated enough sales for their makers to justify the costs of full-dress testing. These costs would be less than those for a new drug, since such factors as safety would not be at issue, but they would still be quite substantial. Thus, many drugs with distinct if limited uses would simply become unavailable to the patients who needed them, creating, at one stroke, a whole orphanage full of former grandfathers. Finally, the law stipulated that the FDA could not withdraw marketing approval from a previously marketed drug until it had provided producers with an opportunity for a hearing, and with only two full-time hearing examiners the agency could not possibly handle all the cases it would trigger by trying to proceed at once.

Not surprisingly, then, the FDA proceeded to implement its review at quite a leisurely pace. "Public interest" groups claimed to be scandalized by the delays, and sued the agency to spur matters on. As happens so often, however, taking the dispute to court turned out to be an ineffective way to speed up its resolution. A district court judge in Washington, D.C., did rebuke the agency sternly in 1972, by which time it had taken final action on less than half the drugs in the NAS survey. But the resulting court order tacitly acknowledged the real difficulties involved: it gave the agency up to four more years to deal with the remaining drugs and held out the possibility of further extensions for drugs that the agency regarded as meeting a "compelling medical need." By 1979, seven years later, the FDA had still failed to take 482 drugs out of limbo. All that a new round of litigation accomplished was to secure a settlement pushing the deadlines out to as late as 1984.

The FDA took a somewhat more creative approach to the over-the-counter (OTC) side of the problem, but there too it ran into trouble from a Nader suit. In the over-the-counter case, testing each product individually would clearly have been impractical, since there were some 400,000 such products. Accordingly the agency commissioned expert panels in 1972 to review and report on the effectiveness of the active ingredients used in twenty-seven broad categories of products, such as pain relievers, cold reme-

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dies, laxatives, and so on. Based on these reports and any additional evidence submitted by manufacturers, the agency would then proceed to issue official monographs listing the active ingredients that were acceptable for use in each type of medication.

The agency planned to classify the OTC ingredients quickly into three broad categories: (1) ingredients that had been firmly proved to be safe and effective, (2) ingredients that had been judged to be unsafe or clearly ineffective, which would automatically be banned, and (3) a residual category of ingredients not yet fully proved effective, but still authorized for sale. In 1979 Nader lawyers succeeded in getting a court order abolishing the third category; it would have to classify all ingredients as either effective or not, regardless of the added burden in doing so. In fact, the agency simply ceased to issue any orders at all for more than two years thereafter. Even now it has published only ten of a projected eighty-five final monographs on acceptable over-the-counter ingredients. (The Nader lawyers are back in court.)

There is some hope for an end to the ordeal. The review of OTC products is now proceeding fast enough that agency sources predict it may be largely finished in three or four years. Moreover, the review of prescription drugs is approaching completion: by 1980, the FDA had taken final action on 87 percent of the prescription drugs in the original NAS survey, and had classified 72 percent of that total as "effective." Even so, counting different formulations of the same substances, the review had forced the withdrawal of several thousand previously legal drugs from the market. Among them were many "combination" drugs, banned on the grounds that they were no *more* effective than their ingredients taken separately. This policy, according to critics of the FDA's effort, ignored the advantages of "double-barreled" treatments in cases where an exact diagnosis was impractical. Physicians could get around this problem by prescribing the ingredients separately, but only at additional cost, and at the risk of less certain patient compliance.

As for OTC products, the agency predicts that when its review is complete perhaps a third of the currently available product families will have to be substantially reformulated or withdrawn entirely. A large share of these are antiquated remedies now sold mostly by mail or through special-order wholesalers to a dwindling band of loyal, often elderly customers. It is worth quoting the late Dr. Michael Halberstam in this context:

> One of the interesting phenomena in clinical pharmacology is that idiosyncratic reactions to a drug are universally accepted as valid—if they are adverse. . . . We accept unquestioningly that some people can be harmed by a drug which in the overwhelming percentage of patients is helpful (or at least innocuous).
>
> It is curious that the converse is not true —a patient who claims unique benefit from a drug that is not generally considered effective is not likely to be believed. . . . Thus, if aspirin relieves discomfort in 40 percent of a population study and Wonder-A does the same, the latter is said to show "no advantage" over aspirin, even though its 40 percent response rate might at least in theory come from a different segment of the population [than aspirin]. [*Too Many Drugs?* AEI Reprint # 102, January 1980]

In the meantime, as *Pills That Don't Work* says, it is quite true that consumers are still permitted to buy hundreds of prescription drugs and thousands of OTC products "that have not been proven effective"—beyond any reasonable doubt, at least. That is, people are still allowed to request and buy products with therapeutic benefits some of which are merely "probable" or "possible," and others of which are nonexistent. It is even possible to find governmental "lethargy" in this circumstance, since the FDA has admittedly given higher priority to its other responsibilities.

But the slow pace of these proceedings is a scandal only if one starts from the assumption (as the Nader books quite explicitly do) that prescribing physicians and patients are incapable of making proper decisions on even repeated purchases of drugs. Under less paternalist assumptions—such as prevail in most other modern countries—the extravagant nature of the testing may appear in a different light. It may seem at best an example of the luxuries a rich country can indulge in, and at worst a woeful waste of medical and scientific resources. As for the other costs of the program—its reduction to "orphan" status of existing drugs that consumers use and value and its rejection of drugs that do have sponsors

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but whose efficacy is merely "probable"—these may seem at best a stifling of harmless cultural diversity and at worst an assault on consumer well-being.

A Case of Labor Market Pains

Effective control of health costs is often thought to require restrictions on individual choice. Many reform plans would establish "gatekeepers" to prevent patients who do not pay their own medical bills from choosing overly expensive kinds of care. That sort of restriction might succeed in cutting costs, but at the price of taking away patients' rights to decide who will care for them and how. Fortunately, for those who are troubled by this dilemma, there are a number of reforms that would combine cost-cutting and wider individual choice, by setting patients free to choose *lower*-cost alternatives that are now unavailable to them. Foremost among these reforms would be to let nurses, paramedics, medical technicians, and other members of so-called allied health professions handle more of the tasks now reserved for doctors. This particular reform effort has run into tremendous opposition from the doctors themselves, however, and perhaps nowhere more than in the case of nurse-midwives.

Up through the early twentieth century most babies were born with the assistance of midwives. The profession got a very bad press, however, in the reformist literature of the turn of the century. Such works as Upton Sinclair's *The Jungle* portrayed venal or superstitious "lay" midwives (midwives without formal medical training) whose ignorance endangered both mother and child. Enlightened opinion was rallied to suppress the practice. Most states passed laws heavily regulating lay midwifery, and some outlawed it altogether, stipulating that only doctors and registered nurses could deliver babies. Furthermore, most states require a doctor's collaboration in any event.

In the 1960s, however, midwifery began to make a comeback, for reasons that went well beyond the issue of affordability. The home-birth and natural-birth movements arose to argue that obstetricians have relied on superfluous and perhaps hazardous medications and technologies. The rise of feminism led many expectant mothers to prefer to be attended by a (usually female) nurse rather than a (usually male) doctor. Moreover, midwives could offer a mother continuous care, while an obstetrician supervising several deliveries was likely to drop in and out of the room—another example of how "caring" as well as "curing" can be important to patients.

Some doctors still claim that midwifery is less healthful than physician care, but the midwives respond that their services are perfectly safe under modern conditions of practice, perhaps even superior in quality. They cite statistics from a New York City clinic and from rural California suggesting that nurse-midwife care brought about significant improvements in infant survival rates and other measures of well-being. Midwives can quickly call in a doctor's help in the minority of cases in which complications arise. The American College of Obstetricians and Gynecologists joined with the American College of Nurse-Midwives in November 1982 to issue a joint statement emphasizing that "quality of care is enhanced by the interdependent practice of the obstetrician/gynecologist and certified nurse-midwife . . . [which] does not necessarily imply the physical presence of the physician."

Despite these fine words, nurse-midwives have been subjected to no end of regulatory grief. In the District of Columbia, for example, local law does not explicitly refer to midwives —referring only to the practice of nursing generally—so that they are not reimbursed by Medicaid. (Nurse anesthetists have also run into trouble on federal reimbursement: see "Is HHS Trying to Deaden the Pain of Competition?" *Regulation*, January/February 1983.)

More often it is the exact relation between midwife and doctor that causes the regulatory controversy. Many physicians would prefer to reserve for themselves such functions as the prescribing of drugs. ("Good fences make good neighbors," they say.) Some state licensing boards dominated by physicians are tightening restrictions on the scope of professional practice of both doctors and nurses. The Arkansas medical board, for example, has prohibited doctors from supervising any more than two nurse-midwives at a time. The New Jersey, Kentucky, and Maryland boards recently considered but did not adopt regulations to restrict the nurse-midwives' scope of practice.

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Meanwhile, hospitals in such cities as Richmond, Virginia, have come under pressure to grant hospital privileges to midwives and other health professionals, thus allowing them to admit, diagnose, treat, and discharge patients. In the regulation-charged atmosphere of modern hospital administration, this sort of decision has become a political rather than a private decision—all the more so because the allied professionals charge that the hospitals' credentials committees are dominated by physicians, who are thus in a ticklish antitrust situation. Again, the District of Columbia has been a major battleground. Doctors in the medical society there have fought against granting hospital privileges to nurse-midwives, nurse-practitioners, and podiatrists, and one major hospital revoked the nurse-midwives' privileges, accusing them of straying beyond their permitted scope of practice to perform general gynecological exams.

Among the objections the doctors sometimes raise is one of cost. If allied professionals can admit patients, they assert, hospitals will have to add more personnel to their payrolls and costs will inevitably increase. They point out that hospital staff increased by 100 percent from 1960 to 1980, even after adjustment for the rise in population, and that this was a major factor in the general run-up in health costs.

The question is to what extent the allied professionals are adding to the total demand for services and to what extent they are simply substituting for the services of physicians. According to an article in the *American Journal of Obstetrics and Gynecology*, "The most significant decrease in health and medical costs that may result from collaborative practice [between a physician and nurse-midwife] is the substitution of the cost of physician resources. Clearly, more expensive physician time may be replaced by less costly nurse time." If this substitution effect outweighs the "demand creation" effect, expanding the use of midwives should help reduce health outlays. And although nurse-midwives may spend more time with their patients, they do not seem guilty of oversupplying services in general, since their cost per delivery is lower than that of doctors. Of course, the advance of midwifery could boost spending if it led to more deliveries, but the supply of new babies to deliver probably does not increase markedly when mothers are offered new ways of delivering them.

Whether because of increased activity by other professionals, incidentally, or because the population is growing more slowly than the number of doctors, the medical establishment is beginning to feel the spur of competitive pressure. The Minnesota state medical association found in a recent survey that nearly 40 percent of its members thought their communities were oversupplied with physicians, whereas only 10 percent of them had thought so five years ago. One result has been an upsurge of protectionist activity within the medical profession itself. The House of Delegates of the California state medical association, for example, asserted earlier this year that "physicians seeking to resettle in California are not a needed resource," and called for an end to automatic reciprocity between the states in physician licensing. As the pressure intensifies, professional groups will increasingly have to choose whether to devote their efforts to raising more barriers or whether to become midwives themselves, assisting at the birth of a more open and competitive health care system.

Clean Water: Apocalypse Later

Nineteen eighty-four is fast approaching, and commentators will soon churn out articles by the hundred on the significance of reaching the fateful Orwellian year. For regulatory buffs, however, the truly apocalyptic date is not 1984 but 1985. That is the year specified in the Clean Water Act for the goal of zero discharge of pollutants into the nation's lakes and streams. According to Martin Bailey (*Reducing Risks to Life*) this goal "may be technically impossible; the capital cost of closely approaching [it] would quickly exceed one year's national product, and the operating cost would consume a substantial fraction of every year's product." Just attaining the interim "fishable and swimmable" goal set for 1983 (and missed) would have cost $468 billion, not counting whatever might have been required to limit agricultural runoff, according to a 1975 estimate by Allen V. Kneese and Charles L. Schultze for the Brookings Institution.

The amount actually spent on the clean water program so far is lower than this, but far from negligible. Counting both public and pri-

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In Brief–

Scenic Resources Redistributed. Under an agreement between a California motel and state regulators, some travelers get to stay in the rugged Big Sur area at a cut rate. When the Tickle Pink Motor Inn wanted permission to build a six-room addition in 1980, the California Coastal Commission made it agree to offer one of its rooms as a "lower cost visitor facility," according to the *Wall Street Journal*. So the motel charges only $30 for the bargain room and $82 to $96 for the others. The provision was supposed to help poverty-stricken vacationers, but in fact the motel asks no questions about visitors' financial well-being before it rents them the room.

The Sincerest Flattery. Since the U.S. phone system works well, many foreign observers wonder at the Reagan administration's moves to break it up so as to encourage competition in long-distance telephone markets. The government of Japan, however, does not seem to be among the skeptics. It is reportedly planning to follow the American example—first by dismembering its equivalent of AT&T, and then by partially deregulating it. Perhaps more remarkable, the Japanese telephone company seems to welcome its own breakup.

A bill will probably be filed in the national parliament next year to carve up Nippon Telegraph and Telephone, à la AT&T, into one nationwide long-distance-and-research company and two or more independent regional companies providing local service. The government may sell shares in the local companies to private investors and even foreigners; it will hold onto the stock of the nationwide company for somewhat longer, but will give it more freedom from political oversight in hopes of making it more competitive.

Kanichiro Aritomi, first secretary of the Japanese embassy, says that his country's officials, like their American counterparts, want to free up competitive market forces and believe that continued monopoly is holding up the convergence of computers and telecommunications. The *Economist* adds that because "everybody—with the exception of the telecommunications workers' union—agrees that NTT's monopoly is the biggest obstacle in the way of the wiring of Japan," the dismemberment "is proving fairly painless."

Slowing Down the Charge. Many state governments have been considering moving toward user charges instead of taxes, as a way to pay for their services. But according to a recent article, federal policy may be discouraging them from doing so.

Proponents argue that user fees are efficient, because they discourage wasteful overuse of government services, and fair, because they shift the cost of services to those who use them. State budgeters, meanwhile, are eager to explore any plausible way to raise revenues. The public has been supportive, too: a survey last year by the Advisory Commission on Intergovernmental Relations found that more than half the respondents considered user fees the best way to finance expanded local services, far more than favored reliance on any form of taxation.

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vate spending, it added up to $162 billion between 1972 and 1981, according to Department of Commerce data. Around $40 billion of this money has taken the form of federal grants to help cities build sewage treatment plants that, according to a 1981 *Washington Post* investigation ("Costly Monuments to Idealism Now Lie Rusting in the Mud"), often don't work.

The achievement of the zero-discharge goal would be quite inconsistent with the continued allocation of large portions of the gross national product to purposes other than water pollution control. Assuming that citizens go on spending the GNP on the usual things instead, the entire country will thus lapse in 1985 into a sort of chronic state of noncompliance with the congressional will, as it has already done with respect to the 1983 interim goal.

You might think that this recidivism, along with the massive ongoing cost of the program, would have made for a big controversy now that the Clean Water Act has come up for reauthorization. But you would be wrong. Congress and the Reagan administration are apparently going to leave the zero-discharge clause intact, but simply ignore it. At the same time they are planning to postpone, but not substantially revise, various of the law's other requirements. (The sewer grants, incidentally, were safely reauthorized in 1981, so they are in no danger this year.)

The legislative proposals offered by the Reagan administration have not, as of this writing, been embodied in an actual bill before the legislature. In any case, they are not much different on matters of principle from the leading bills offered by environment-minded members of Congress. These include H.R. 3282, filed by Rep. James Howard (Democrat, New Jersey), and S. 431, filed by Senators John Chafee (Republican, Rhode Island) and Jennings Randolph (Democrat, West Virginia) as modified by the Senate Committee on Environment and Public Works. Both these bills and the adminis-

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The federal government, however, provides at least two disincentives for any move toward fees, according to an article by Steven Gold of the National Conference of State Legislatures, writing in the conference's magazine. First, user fee revenue is not treated the same way as tax revenue in federal revenue sharing allocation formulas. "If a state adopted policies that encouraged its local governments to employ user charges more, their [revenue sharing] aid would decrease." How much? The amount varies because the aid formula is complex, "but for each dollar of tax reduction, revenue sharing falls between 3 cents and 20 cents."

Furthermore, user fees are not deductible on federal income tax returns the way most state taxes are. "This implies that shifting from reliance on general taxation to user charges will increase the federal tax bills of state residents."

Whether for these or other reasons, the popularity of user charges at the town and city level has not been matched at the state level. From 1978 to 1981, in the aftermath of Proposition 13 and the tax revolt, "user charges as defined by the Census Bureau rose from 12 cents to 12.5 cents per dollar of state tax revenue." Before 1978, according to the census figures, they had actually been falling compared with state taxes.

Wipe That Smile off Your Face. The *New York Times* best-seller list has lately been graced by volumes one and two of a work entitled "Truly Tasteless Jokes." To Representative Mario Biaggi (Democrat, New York) this is evidence that "the condoning of racial and ethnic jokes"—not just their commission, but their condoning—"has plunged to new depths," to quote the *Congressional Record.* So he has introduced H.R. 3105, a bill that would establish a complaint bureau in the Federal Communications Commission to "monitor such baseless attempts at ethnic humor." It would also authorize federal funds for educating the public on the issue.

Although his bill would reach only television and radio, not publishing (which it turns out falls under the First Amendment), Biaggi says he believes "books such as these, which serve no positive role in building the moral fabric of our society," would become less popular as the government made it clear that they "are a dangerous influence on our young people." There is no word on what effect a campaign against humor would have on the *Congressional Record* itself.

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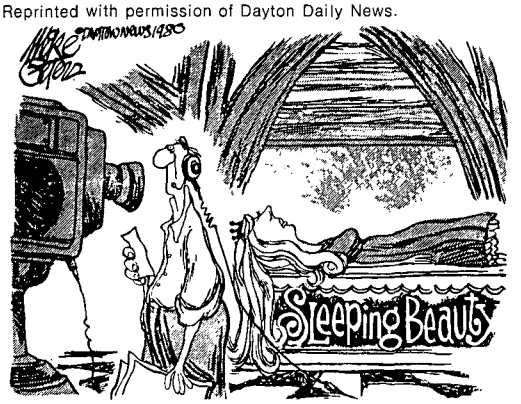
Sleeping Beauty
We've decided AGAINST showing THIS ILL-FATED love story OF A POOR PRINCESS, FOR FEAR OF CREATING A GRATUITOUS SLUR UPON WITCHES, THEIR VALUES AND TRADITIONS...

tration's proposal would delay the compliance deadlines by a few years, generally three. Mostly the differences between Congress and the administration center on whether and how to make the law tougher. Among the topics of controversy, or lack thereof:

- All the major bills would increase criminal sanctions for violating the act. Both the administration bill and S. 431 would increase criminal penalties to a maximum of $50,000 per day of violations and two years in prison. (H.R. 3282 would not.) Knowingly submitting a false material statement to the Environmental Protection Agency would be made a felony under all three bills. It would also be made illegal to introduce into a sewer system, either negligently or knowingly, pollutants that could not be removed by city treatment plants or were otherwise hazardous. Since there is no lower limit on the quantities involved, this could be interpreted to prohibit flushing a cupful of potentially harmful pollutants down a toilet. Incidentally, the 1981 *Post* series reported that hundreds of city officials were already breaking the law and potentially subject to imprisonment because their federally financed sewage plants didn't work.
- Some companies discharge their wastes into municipal sewage treatment plants rather than directly into lakes and streams. Currently these companies have to pretreat the wastes, following EPA's technology-based standards, even if the effluent would have met water quality standards anyway after emerging from the city sewage plant. The administration initially wanted to let cities apply on behalf of such companies to waive EPA's pretreatment standards in such cases; now it is hedging.
- Companies that heat up the water (thermal polluters) currently have to use the best available technology to avoid harming local marine life. The administration would allow companies to use less exacting technologies so long as the resulting population of marine

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life remained "balanced"; currently it has to be "indigenous."

- The original act required towns to build treatment plants even when their sewage output was small and was discharged directly into the ocean (see David M. Shell, "Skagway v. EPA: Cassandra's Prophecy Revisited," *Regulation*, November/December 1980). Public outcry, along with a General Accounting Office study entitled *Billions Could Be Saved through Waivers for Coastal Wastewater Treatment Plants*, prompted Congress in December 1981 to reopen a period during which coastal towns could apply for waivers from the rule. Three of the current bills—H.R. 3282, S. 431, and S. 1536, filed by Sen. Christopher Dodd (Democrat, Connecticut)—would restrict the granting of these waivers. The administration would prefer to leave the current waiver system intact.
- Currently states must achieve lower effluent levels in some streams and lakes for which they have designated special uses such as commercial fishing. Last October EPA proposed changing its regulations so as to let states delist these designated uses in cases where they could prove that costs far outweighed benefits. Later, however, it reversed itself, and endorsed the basic approach of the current regulatory standard, under which states have to prove substantial and widespread economic harm, among other things, before they can delist a use. Senator Chafee has responded by dropping a clause in his bill that would have frozen previously published designated uses so states could not downgrade them, with narrowly limited exceptions. Instead, his bill would turn the current regulation (along with several other tough EPA standards) into statutory law. Supporters of the status quo say they fear that states could easily perform the cost-benefit comparisons needed to justify the downgrading. To the extent that designated uses are effectively frozen, water once kept pristine for oystering will have to be kept pristine forevermore, even if the last oystering company goes out of business.
- The administration is seeking a number of other changes, none important in principle. It would like to exempt munitions from the category of pollutants; the Supreme Court recently held that the Navy must get an EPA permit before carrying out target practice that would result in the discharge of ammunition into water. The administration proposal would also remove a requirement that businesses begin complying with new source performance standards as soon as the standards are proposed; instead, they would have to begin complying only when the regulations become final. The bill would also let EPA delegate part of its permit-issuing power to a state, rather than all or none as at present, and would allow the agency to charge fees to polluters for processing their applications for waivers and exemptions. Finally, the administration bill would extend the maximum length of plant discharge permits from five years to ten, in order to ease the oversight burden on EPA and the states. In the absence of any systematic reforms, this last provision would presumably entrench the regulatory principles now embodied in permits, for better or worse; it might also encourage the regulators to scrutinize applications more closely.

The attentive reader will search this list in vain for any mention of cost-benefit analysis of technology-based standards, for "bubbles" or offset trading or emissions fees, or indeed for any of the market-oriented reforms economists have been suggesting over the years. The forthcoming debate on clean water reauthorization will apparently include little controversy over such reforms, because neither camp is willing to endorse or fight for them. The consensus shared by both EPA and its environmentalist critics seems to be that any such reforms can wait until 1988, or such earlier date as the deadlines next have to be postponed.

U.S.-Canadian Railroads: Bordering on Frustration

Can a continent-wide railroad system endure half-slave and half-free—or, to put it less dramatically, half-regulated and half-deregulated? That is what Canadian railroads have been asking themselves ever since their American counterparts began to win their freedom from the U.S. Congress and the Interstate Commerce Commission some years ago.

The Canadians' chief worry is probably antitrust. Their law allows railroads to set rates collectively, which U.S. antitrust law does not. Given the "extraterritoriality" that U.S. courts have found in the Sherman Act, Canadian railroads can be prosecuted for setting rates in

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their own country in ways that affect U.S. imports or exports—even if the Canadians' physical control of the goods stops at the border.

Sherman Act prosecution is not an idle threat to Canadian Pacific and Canadian National, the two major Canadian railways. Freight bound for the United States makes up about a quarter of their traffic. Although they usually transfer goods at the border to U.S. carriers, they also operate sizable subsidiaries in this country: Canadian Pacific owns the Soo Line Railroad and Canadian National owns the Grand Trunk, along with smaller lines. These extensive properties provide easy targets for the Sherman Act's criminal penalties (up to $1 million per count for companies, and $100,000 plus three years in jail for executives) and for the treble damages that can be awarded to private complainants. Canadian shippers' groups are also open to Sherman Act assault, since they often negotiate collective rates. So, conceivably, is a U.S. railway that cooperates with a Canadian railway to set a combined rate on a U.S.-Canada shipment knowing that its partner has set its rate collectively.

So far the Canadian railways and shippers have managed to fend off the extraterritorial menace, with the help of a formal diplomatic note from their government. The ICC gave them temporary immunity from antitrust in 1981 when it agreed to treat all Canadian railways as "one integrated enterprise." (It also granted immunity to the Canadian shippers and U.S. rail carriers for their involvement in Canadian rate-fixing.) This was hardly unprecedented: in 1978 the U.S. Civil Aeronautics Board gave foreign air carriers immunity to set fares collectively through the International Air Transport Association.

The granting of temporary immunity, of course, has simply changed the fight to one over whether the grant should be made permanent. The Canadian railways have tried to be helpful, even going to the lengths of outlining a process by which they would keep U.S. railroads that operate in Canada (Conrail, Norfolk Southern, Chessie, and Burlington Northern) from using meetings of the Canadian Freight Association to covertly discuss rates they charged in the United States. The Justice Department has gotten into the act, too, objecting that the ICC could not legally confer antitrust exemptions for types of traffic that it had completely deregulated, such as containerized flat cars and shipments of fresh fruits and vegetables. In the meantime, the Canadian railways say they have been complying with U.S. antitrust law (except in the case of shipments that are covered by U.S. rate bureaus of which the Canadians are members, since these bureaus still have some residual antitrust immunity).

Inconsistency between U.S. and Canadian law is also causing problems in the area of confidential rebates and contracts between railroads and shippers. In the United States, both are legal: contracts are filed with the ICC but are available to the public only in summary form, so that the exact amounts of the rebates and the nature of concessionary terms are kept secret from competing railways and shippers. These rebates have become a major mode of competition between U.S. carriers. In Canada, however, both contract secrecy and confidential rebates among railroads are prohibited: all rates and terms of contracts must be published. So although the U.S. railways can sign contracts with shippers on cross-border traffic, the Canadian railways cannot join in the contracts or give rebates of their own.

This has several competitive implications. Prices for most Canada-U.S. traffic are quoted in terms of a "through rate"—a single combined rate for the whole trip which the two or more railways involved have agreed to split among themselves in some manner. Historically, such through rates have been more common (and lower) than "combination rates" in which each railway charges the shipper a separate rate for its link of the movement. The reason is that the participating lines can adjust through rates more easily to keep them (and their customers) competitive with alternate routes.

Canada requires railroads to publish the full amount they charge for through rates from the United States to Canada, but the U.S. railways have (according to the Canadian lines) been ignoring this requirement, on the grounds that they carry the goods only within U.S. boundaries and are thus not subject to Canadian jurisdiction. To make matters especially confusing, northbound and southbound traffic may be subject to different rules. Canadian law explicitly requires every participating line to file through rates on southbound traffic ("the several companies shall file") but does not

(Continues on page 52)

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Viewpoint

Murray Weidenbaum and Michael Munger

Protection at Any Price?

WHILE MANY TYPES of federal regulation have been reduced somewhat in recent years, one type has grown in both scope and intensity—restrictions on trade with other nations. Of course, protectionist barriers usually increase in severity during periods of high domestic unemployment, and there is no reason why the recent downturn in economic activity should have been any different. The problem is that the protectionist trend is continuing unabated during the current economic upturn.

In 1981–82, the United States imposed or negotiated higher trade barriers on a wide array of products, including bolts, screws, and heavy industrial fasteners, cement and other road construction materials, numerous carbon and specialty steel products, Japanese light trucks and motorcycles, and textiles and apparel from mainland China. More recently, explicit export subsidies, long eschewed by the United States, were put in place this spring and summer on U.S. wheat, milk, and cheese shipped to Egypt—as a means of retaliating against similar European practices. In June, following a recommendation from the International Trade Commission, President Reagan raised new barriers against a number of foreign specialty steel products such as hardened alloy tool and some types of stainless steel. Meanwhile, Congress continues to entertain the domestic content bill (S. 707 and H.R. 1234), which would require high-volume automakers, after a phase-in period, to produce domestically at least 70 percent of the value of the cars they sell in this country. This requirement would present great obstacles to Japanese auto producers.

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Who Bears the Costs?

Protectionist policies consist of tariffs, quantity limitations (quotas or bilaterally negotiated agreements), and a variety of other regulatory barriers such as "Buy American" laws, discriminatory quality standards, and the trigger price mechanism. These policies are intended to help certain industries and save certain jobs—and, indeed, they may succeed, though only in the short run. But, we should ask, at what cost and to whom? The costs take two forms: protected domestic products become more expensive, and restricted imported products become both more expensive and less available. The largest single group that bears the cost of protectionism—domestic consumers—is probably the group least aware of the costs. After all, those costs are often widely dispersed and hard to identify. Who could track down the ramifications of higher prices of bolts, cement, specialty steel, or even apparel?

Consumers are not the only group bearing the costs of U.S. trade policy. Among the other victims are U.S. producers of unprotected goods, especially producers of goods exported to other nations. They are hurt directly when foreign countries retaliate against U.S. trade barriers, and indirectly when our trade barriers succeed in limiting foreign imports and thereby make it harder for foreigners to obtain the dollars they need to buy U.S. products. Indeed, once the balance of trade readjusts, exports fall by as much as imports. Similarly, some domestic producers are hurt because they have to pay higher prices for protected inputs. Thus, for example, domestic automakers that

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use protected steel have trouble competing with foreign automakers that can buy lower-priced steel on the world market. This leads U.S. automakers, like other producers in similar situations, to request protection.

While the costs that protectionism imposes on producers are probably not a trivial component of the total, only the costs borne by U.S. consumers are examined here. The burden that tariffs impose on consumers can be divided into three parts: (1) the tariff revenue itself, which is an explicit tax that transfers funds from consumers who buy the imported product to the government, (2) an implicit tax or transfer of funds from consumers to producers, reflecting the increased prices of protected domestic products, and (3) dead-weight static losses, caused by the misallocation of resources that trade barriers encourage. Quantity restrictions and other regulatory barriers raise no revenue for the government, but do impose both the second and the third of the above costs.

That trade barriers are, in effect, a tax can be seen by realizing that the government could choose to support a faltering domestic industry either by protecting its market from foreign competition or by taxing consumers and subsidizing the industry with the proceeds. In the case of all three forms of protectionism, the transfer to the protected industry is directly from the consumer, rather than from the consumer via government.

Measuring the Costs

The technique we used to estimate the total "hidden tax" borne by consumers was to assemble from the existing literature cost estimates for specific programs, and then to make additional estimates of our own for some tariffs where the required data were available. Our literature search turned up twenty-one studies giving figures for various tariffs, quotas, orderly marketing agreements, and the trigger price mechanism. Our tariff estimates were derived by taking the average U.S. tariff rates after the Tokyo Round of multilaterally negotiated reductions (as estimated by Alan V. Deardorff and Robert M. Stern, *Southern Economic Journal*, January 1983), and multiplying them by total domestic consumption. All estimates were adjusted as necessary to 1980 prices.

The results appear in Table 1—a total of $58.5 billion in costs imposed on consumers in 1980. Two aspects of this estimate should be emphasized.

First, the figure substantially understates what the consumer actually pays for protectionism because the underlying estimates are incomplete. Part of the reason for this is that they reflect the static, or short-run, costs, but not the dynamic costs. And, as Ilse Mintz explained in her pioneering study for the American Enterprise Institute,

> Dynamic costs may, in the long run, far exceed static ones. But they can be measured only on the basis of intensive and detailed studies of each of the industries affected. . . . Such studies are not available, and all one can do is to keep in mind that the static costs . . . are only part of the story [*U.S. Import Quotas: Costs and Consequences*, 1973].

Dynamic costs include losses in capacity, innovation, or productivity that occur when firms are insulated from market forces that give impetus to corrective changes in industry structure and production methods. Trade restraints keep resources in relatively unproductive industries and increase the costs of labor and materials for industries that otherwise would have a higher competitive potential. Any industry that is insulated for a substantial period against the pressure of international markets is likely to find itself far behind its competition, saddled with obsolete methods and equipment.

Table 1

COSTS OF PROTECTIONISM TO U.S. CONSUMERS
(billions of 1980 dollars)

	Types of Restriction		
Product category	Tariffs	Quantity limitations and other barriers	Total
Textiles and apparel	$15.0	$ 3.4	$18.4
Machinery and transport equipment	15.9	—	15.9
Metals and minerals	7.3	2.8	10.1
Other manufactured products	5.5	2.6	8.1
Agricultural	2.1	3.9	6.0
TOTAL	$45.8	$12.7	$58.5

Source: Michael C. Munger, "The Costs of Protectionism."

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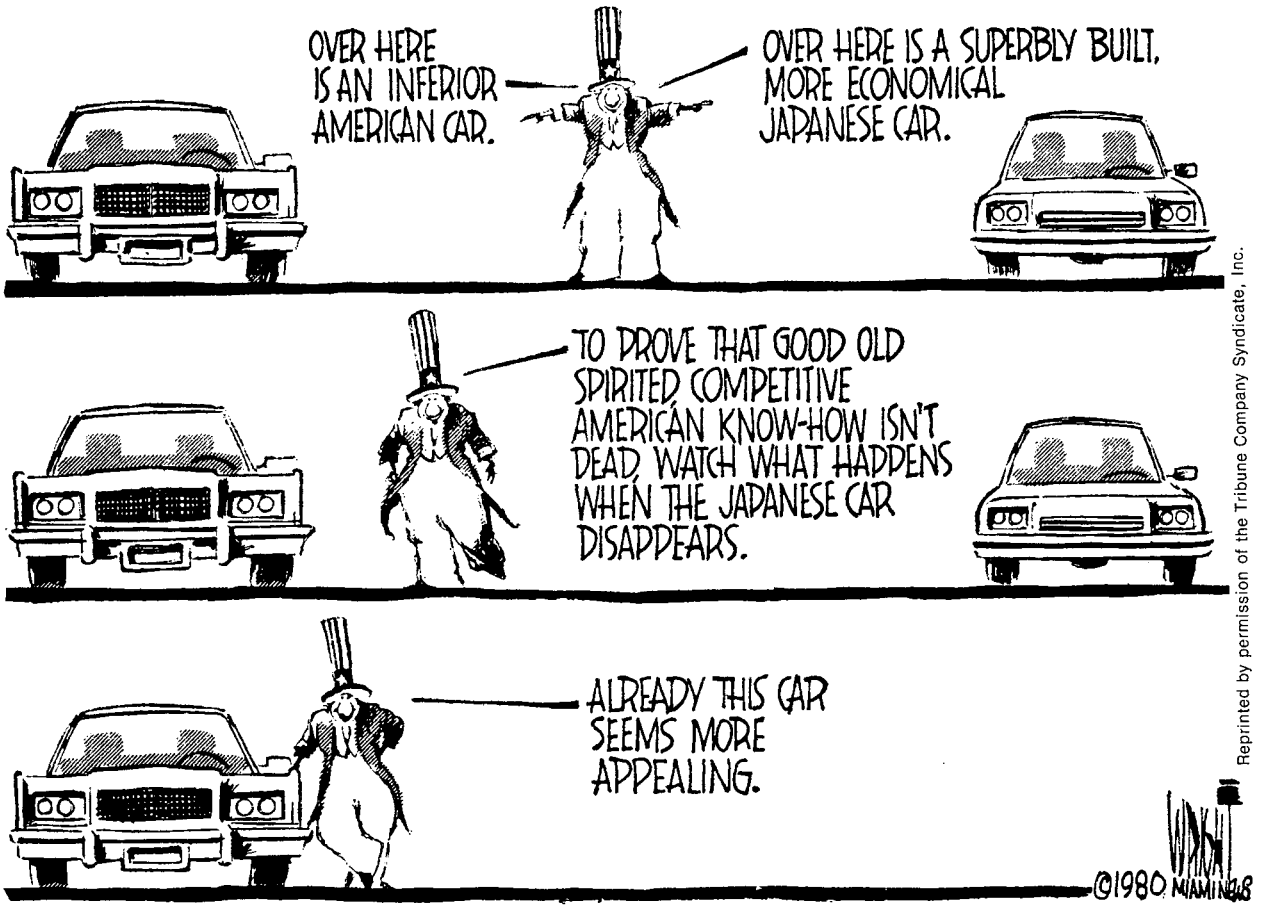
OVER HERE IS AN INFERIOR AMERICAN CAR.
OVER HERE IS A SUPERBLY BUILT, MORE ECONOMICAL JAPANESE CAR.
TO PROVE THAT GOOD OLD SPIRITED COMPETITIVE AMERICAN KNOW-HOW ISN'T DEAD, WATCH WHAT HAPPENS WHEN THE JAPANESE CAR DISAPPEARS.
ALREADY THIS CAR SEEMS MORE APPEALING.
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Our overall estimate is also understated because the static cost estimates are themselves incomplete. They do not include orderly marketing agreements on autos, ball bearings, batteries, dairy products, meat, mushrooms, and tin. Nor do they include building code restrictions on ceramic tile, the fruit juice tariff (averaging 27 percent), "Buy American" limitations on government procurement, and the Jones Act rules on the use of U.S. flag vessels. While the orderly marketing agreement for mushrooms may be a trivial omission, the "voluntary" restrictions on autos, dairy products, and meats create substantial transfers of income. A significant part of this transfer comes about because foreign producers respond to quantity limitations by shifting their exports from cheaper to more expensive goods. Japanese automakers, for example, have stayed within their U.S. quota, while increasing their sales revenues, by exporting to this country larger numbers of higher-priced cars loaded with more accessories. The result is that low-income customers find fewer products available in their price range.

The second point to stress about our overall estimate is that, even though it is incomplete, it represents a significant and little-recognized burden to the consumer. Trade barrier costs of $58.5 billion in 1980 amounted to an implicit per-capita tax of $255 that year—or $1,020 for the average family of four—to protect a variety of domestic industries. If we adjust for inflation but make no allowance for the many protectionist programs that have been

Trade barrier costs of $58.5 billion in 1980 amounted to an implicit per-capita tax of $255 that year—or $1,020 for the average family of four. . . . If we adjust for inflation . . . the total cost for 1983 is $71 billion.

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added since 1980, the total cost for 1983 is $71 billion.

Turning to some details of our figures, the total tax or transfer associated with tariffs is about $45.8 billion, with another $12.7 billion resulting from quantity limitations and other regulatory barriers. In the product category totals, the largest cost is for textile and apparel restrictions—$18.4 billion, of which only $3.4 billion is derived from quantity limitations. Given that the textile and apparel trade is heavily affected by such quantitative pacts as the Multifiber Arrangement, the figure for these costs would probably be many times larger if they were not so difficult to estimate.

The second largest cost is for machinery and transportation equipment restrictions—at $15.9 billion. This figure does not include any costs at all for quantity restrictions on autos (the most significant omission) and other items, again because of gaps in the existing literature. The metals and minerals category of $10.2 billion includes restrictions on aluminum, copper, iron, steel, zinc, and various other metals and minerals. Fourth, restrictions on miscellaneous manufactured goods include footwear, furniture, stainless steel flatware, glass products, printing and publishing, and myriad other products. Finally, for agricultural products, quantity restrictions contribute more to the cost burden than tariffs: $3.9 billion of the agriculture total of $6 billion comes from quotas and orderly marketing agreements.

The Long-run Costs of "Saving" Jobs

In light of these large costs, it is difficult to understand the popularity of trade barriers as national policy—except in light of the politics of protectionism. All of the protectionist devices are means by which small, well-organized groups use the political process to their advantage. That the tax effects of these devices are hidden is of no small importance in explaining their attractiveness to policy makers and to business. Certainly, direct subsidization of producers leading to increased taxes—or, more likely, to increased deficits—would be very unpopular politically. Protectionist aid to industries facing strong foreign competition, on the other hand, can be rationalized by pointing the finger at foreigners. In addition, such aid does not threaten company managements with the direct government intervention that explicit subsidies would involve.

The ability of protectionist barriers to save jobs is limited and can never be viewed as more than a temporary measure. But the cost is difficult to justify even in the short run. Table 2 gives estimates of the total cost per job "saved" by five protectionist programs. The ratio of the consumer costs for those programs to the compensation paid to workers ranges from 3.5 for carbon steel to 9.3 for restrictions on footwear imports. Put simply, current protectionist policies "save" jobs at a cost to consumers that is many times what a job is worth to the worker being protected. The difference between the compensation paid and the total implicit transfer from consumers goes partly to the owners of the protected firms and partly to sheer waste (because resources are used to produce goods domestically that could be produced more cheaply elsewhere).

The ratio of the consumer costs for [protectionist] programs to the compensation paid to workers ranges from 3.5 for carbon steel to 9.3 for footwear.

Table 2

ESTIMATED ANNUAL COSTS TO CONSUMERS PER JOB PROTECTED
(1980 dollars)

Product	Average Compensation	Consumer Cost per Job Protected	Ratio of Cost to Compensation
Television receivers (tariffs and quotas)	$12,923	$ 74,155	5.7
Footwear (tariffs and quotas)	8,340	77,714	9.3
Carbon steel (tariffs and quotas)	24,329	85,272	3.5
Steel (trigger price mechanism)	24,329	110,000	4.5
Autos (proposed "domestic content" bill)	23,566	85,400	3.6

Sources: Compensation figures are from Department of Labor, "Labor Force Statistics Derived from the Current Population Survey: A Databook," vol. 1 (September 1982), adjusted to include fringe benefits. Estimates of the consumer cost per job created in television, footwear, and carbon steel are derived from Robert Crandall, in *Brookings Papers on Economic Activity*, 1978; the estimate for steel comes from Crandall, in *Regulation*, July/August 1980, and that for autos from a Council of Economic Advisers staff study.

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Moreover, even these very expensive benefits to workers may be short-lived. There is, as already noted, a tendency for trade barriers to proliferate, as firms that sell products in open markets but buy materials in protected markets find they too need some form of protection. There is also the possibility of foreign retaliation. Our trading partners may succumb more readily to domestic political pressures to raise trade barriers if we have increased ours. The devastating beggar-thy-neighbor policies many nations practiced following U.S. passage of the Smoot-Hawley tariff in 1930 should serve as a vivid reminder of the global repercussions of protectionism.

Moreover, in addition to the direct consumer costs estimated here, trade barriers impose high long-run costs on the protected industry itself. Even the benefits of trade barriers to the protected industry are not unambiguous, because an industry that once sought protection as a short-run cure often ends up dependent on it for survival. Finally, and most important of all, trade barriers damage our economy's competitive strength. As William Brock, U.S. trade representative, has said: "Nations which protect their economies today will pay the costs of a decline in competitiveness tomorrow."

IN THE CURRENT ENVIRONMENT, international trade policy will not sit still. Our choice today is between further drift to global protectionism or a joint effort by the United States and its trading partners to remove the obstacles already threatening open world markets. The longer we wait, the more numerous the barriers and the more difficult the task of removing them. ■

Selected Readings

For the methodology and sources underlying the cost estimates, see Michael C. Munger, "The Costs of Protectionism: Estimates of the Hidden Tax of Trade Restraint," Washington University, Center for the Study of American Business, Working Paper no. 80, July 1983. On the politics of protectionism, see Weidenbaum, Munger, and Ronald J. Penoyer, *Toward a More Open Trade Policy*, Washington University, Center for the Study of American Business, January 1983. For cost estimates on autos and steel respectively, see "The High Cost of 'Local Content,'" Perspectives, *Regulation*, November/December 1982, and Robert Crandall, "Steel Imports," *Regulation*, July/August 1980.

Worth Noting–

In 1847, after France put a tariff on all foreign goods to help domestic industry, the economist Frédéric Bastiat responded with this tongue-in-cheek extension of the protectionist principle:

PETITION OF THE MANUFACTURERS OF CANDLES, TAPERS, LAMPS, CANDLESTICKS, REFLECTORS, SNUFFERS, EXTINGUISHERS, AND OF THE PRODUCERS OF OIL, TALLOW, RESIN, ALCOHOL, AND GENERALLY EVERYTHING CONNECTED WITH LIGHTING

To the Members of the Chamber of Deputies

Gentlemen:

. . . We are suffering from the intolerable competition of a foreign rival, enjoying, it would seem, conditions so far superior to our own for the production of light, that he absolutely inundates our national market with it at a price fabulously reduced. . . . [This rival] is none other than the sun. . . .

We demand that you pass a law ordering the closing of all windows, shutters, dormer-windows, curtains, casements, blinds, bull's-eyes, shades; in short, of all openings, holes, chinks, and fissures through which the sun is accustomed to enter houses in detriment to our fine industries. . . .

If you thus create a need for artificial light, what industry in France would not in the end prosper by it? If more tallow is consumed, more oxen and sheep will be needed. . . . If more oil is consumed, then we shall see more cultivation of the poppy, the olive-tree. . . . The same is the case with navigation: thousands of vessels will be engaged in whale fishing. . . . There is perhaps not a single Frenchman, from the wealthy stockholder to the humble matchseller, who would not profit.

Choose, but be consistent; for so long as you exclude, as you do, coal, iron, wheat, foreign textiles, in proportion as their prices approach zero, what a contradiction it would be to let in the light of the sun, whose price already stands at zero the whole day long!

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After the Legislative Veto

Restoring the Separation of Powers

Theodore B. Olson

On June 23 the Supreme Court added the name Jagdish Rai Chadha to the honor roll of individuals who are remembered, not for their deeds, but for their singular timing in having been associated with a momentous exposition by the Supreme Court of the meaning of the Constitution. Mr. Chadha's exhilarating legal odyssey seemed hopeless in December 1975 when the House of Representatives passed a resolution requiring that he and five other immigrants be deported, notwithstanding the U.S. attorney general's decision to suspend his deportation (along with 339 others) for humanitarian reasons. Eight years later, after his case was submitted for decision twice in the Ninth Circuit Court of Appeals and twice more in the Supreme Court, the Supreme Court ended his jeopardy by proclaiming that the House resolution was unconstitutional.

In *Immigration and Naturalization Service* v. *Chadha* and in summary dispositions two weeks later of two other cases (*Process Gas Consumers Group* v. *Consumers Energy Council* and *United States Senate* v. *Federal Trade Commission*), the Supreme Court conclusively rejected the innovative and imaginative legislative veto device, thus bringing to a climax six decades of increasing tension between the executive and legislative branches over how federal laws are made in this nation and how and by whom they shall be enforced. The Court's *Chadha* opinion, in which five other justices joined, was delivered by Chief Justice Warren Burger. Justice Lewis Powell concurred in the result, but would have decided the case on narrower grounds. Justice William Rehnquist dissented on grounds which avoided the constitutional issues. Justice Byron White issued a forceful dissent.

Many have described these decisions as a dramatic shift in power away from Congress and toward the presidency. One member of Congress called *Chadha* a "train-wreck" for government. Another was quoted as saying, "Oh, my God, the floodgates are open." The *Washington Post* editorialized in its headlines: "Hill's Hard-Won Gains of a Decade Wiped Out" and "Decision Alters Balance of Power in Government." However, hyperbole from the protagonists aside, the decisions actually represent not a shift of power but a timely halt to a gradual but major erosion of presidential authority, an erosion threatening the balance of power between the two political branches of our national government so carefully structured in Philadelphia in 1787. They provide an ideal occasion for a badly needed reexamination of the allocation of governmental power and accountability in this country.

A reappraisal of where unplanned governmental evolution has been taking us is well

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overdue. The judiciary has turned increasingly from deciding cases and interpreting laws to supervising the manner in which laws are executed and how appropriated funds should be spent. Congress (and its 300-odd committees and subcommittees), having taken on more work than it can possibly handle participating in the execution of the laws which it has passed, has precious little time left for the larger issues for which it is best suited. Responsibility is all too readily vested in "independent" (read "unaccountable") agencies which have become more and more remote from the citizens they govern. Commissions and panels regrettably seem to be the only entities sufficiently respected to make widely acceptable decisions regarding matters as important as which missile system to construct or how to preserve social security.

The Proliferation of the Veto Weapon

Legislative vetoes are both symptomatic and illustrative of these trends. Over the last six decades, various forms of the device have been appearing as major appendages to a vast array of legislative enactments. The concept is seductively appealing and mechanically simple. In its basic form, Congress attaches to the exercise of statutory or constitutional authority by the President, by an executive branch department, or by one of the "independent" regulatory agencies a procedure pursuant to which, usually within a specified time, a decision may be reversed by a disapproval resolution adopted by one house of Congress (the "one-house veto"), both houses (the "two-house veto"), or even a congressional committee or a combination of committees. Another form of legislative veto provides that some type of affirmative vote by one or more committees or one or both houses is necessary to validate an executive action, meaning that the action, rather than being subject to a nullification resolution, is no more than a proposal unless and until approved by some action in Congress. Yet another variation permits either nullification or affirmation by one house to be determinative unless a contrary resolution is adopted by the other house. This variation is called the "one-and-one-half-house veto." In all cases, the congressional "veto" or "approval" is the final legally significant action. It is not forwarded to the President for his approval or veto. Indeed, a study by the House Committee on Foreign Affairs recently described the legislative veto mechanism in the War Powers Resolution—which set the "standard for later enactments, particularly those designed to recapture power for the Congress away from the executive branch"—as an "attempt by Congress to avoid the Presidential veto. . . ." (*The War Powers Resolution*, 1982).

Congress has attached legislative veto mechanisms to virtually every type of executive branch and regulatory agency action—to decisions that are primarily administrative in nature, to those that are "quasi-legislative" (rulemaking), and to such matters as the reprogramming of appropriated funds or the deferral of the obligation of specific appropriations. A few examples are useful to illustrate the breadth and variety of the practice:

- The War Powers Resolution provides, among other things, that in the absence of a declaration of war or specific statutory authorization, U.S. armed forces engaged in hostilities outside the United States "shall be removed by the President if the Congress so directs by concurrent resolution." (Concurrent resolutions, unlike joint resolutions, are not presented to the President for his approval or veto.)
- The provision at issue in *INS* v. *Chadha* allowed the attorney general to suspend the deportation of any alien in cases of extreme hardship, but required him to proceed to deport any such alien if "either the Senate or the House passes a resolution stating in substance that it does not favor the suspension of such deportation."
- The Federal Pay Comparability Act provides that the President must select an agent to recommend federal employee compensation based on comparability with private sector wages. The President may either adjust pay rates in conformity with such recommendations, or forward an alternative plan to Congress, which becomes effective unless either house adopts a resolution disapproving the plan, in which case the President must implement the agent's report.
- Committee vetoes: For example, the Department of Transportation may expend appropriated funds to sell Washington, D.C.'s Union Station only if authorized by the House and Senate appropriations committees; or it may

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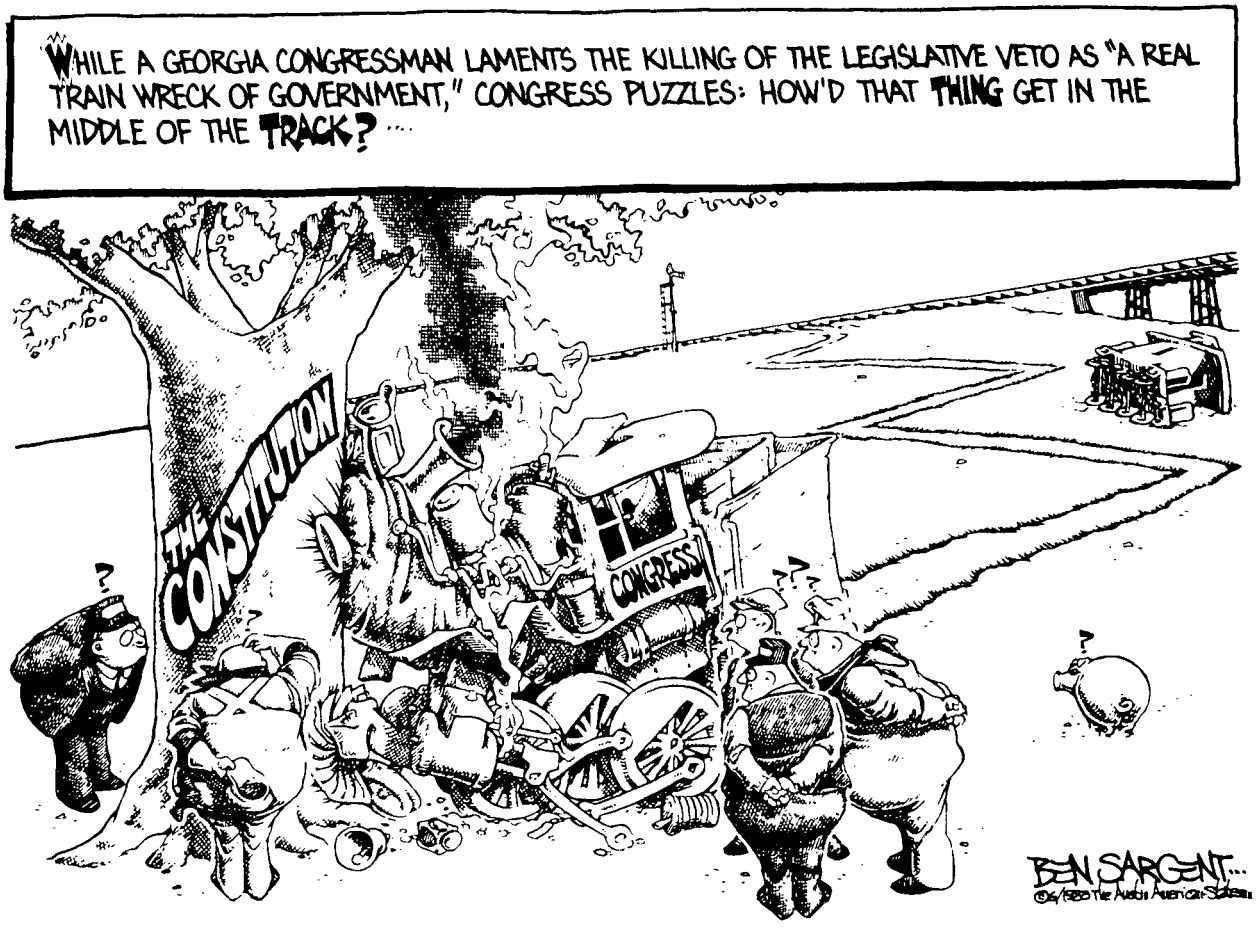
spend funds above certain levels to rehabilitate Union Station, but only if it receives approval from one of two other congressional committees. The Federal Aviation Administration may reorganize its regional office structure if the appropriations committees approve.

- Rulemaking: For example, rules promulgated by the Department of Education, an executive department, and the Federal Trade Commission, an independent agency, are subject to disapproval by concurrent resolutions.

The list of other major statutes that contain some form of legislative veto is impressive and long. It includes the Export Administration Act, the Arms Export Control Act, the National Emergencies Act, the statute providing for promulgation of Rules of Evidence by the Supreme Court, the Nuclear Non-Proliferation Act, the Neutrality Act, the Congressional Budget and Impoundment Control Act, the Outer Continental Shelf Lands Act, the Atomic Energy Act, the Federal Election Campaign Act, the District of Columbia Self-Government and Governmental Reorganization Act, and many, many others. Congress has established broad and pervasive power to reverse decisions made by the agencies and the executive branch, without having to pass laws in order to do so.

Presidential Objections

Our early history contains some intriguing references to congressional resolutions that operated much like legislative vetoes. But the initial twentieth-century experiment with the device has been traced to the administration of Woodrow Wilson, who vetoed an appropriations bill containing a provision that certain documents could not be printed without congressional committee approval. During the Hoover administration, executive branch reorganization authority containing a one-house veto provision was passed by the Congress and signed by the President. One year later, the attorney general questioned the constitutionality of that provision and also advised President Hoover that an enrolled bill which provided


WHILE A GEORGIA CONGRESSMAN LAMENTS THE KILLING OF THE LEGISLATIVE VETO AS "A REAL TRAIN WRECK OF GOVERNMENT," CONGRESS PUZZLES: HOW'D THAT THING GET IN THE MIDDLE OF THE TRACK? ....
THE CONSTITUTION
CONGRESS
BEN SARGENT...

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that illegally or erroneously collected taxes could be refunded only with the approval of a joint congressional committee on taxation was unconstitutional. He reminded Hoover that "[e]ach President has felt it his duty to pass the executive authority on to his successor, unimpaired by the adoption of dangerous precedents. . . . The proviso in this deficiency bill may not be important in itself, but the principle at stake is vital." Hoover vetoed the bill. Congress, possibly influenced by the attorney general's legal analysis, omitted the legislative veto provision from the next reorganization bill, only to include it again in 1939. In succeeding years, legislative vetoes were added to legislation with gradually increasing frequency. The experiment became common practice in the 1970s. President Carter complained part way through his presidency that more legislative veto provisions had been passed in the previous four years than in the preceding twenty. Unfortunately, his message fell on deaf ears and the tempo, if anything, increased.

While every President since Hoover has had some occasion to object to congressional efforts to erode presidential powers by affixing legislative vetoes to substantive legislation, there have been times when Presidents have supported, acquiesced in, or simply winked at the practice. Constitutional reservations were occasionally either ignored or rationalized away. Pragmatism and the exigencies of the moment are strong forces in practical politics.

There is some facially appealing logic behind legislative vetoes. In the first instance, Congress delegates vast and generally unchecked policy-making power to executive and independent agencies. Therefore, why not, in the interest of retaining that policy-making power in the hands of the elected representatives, place a congressional check on excessive regulations, regulations that go beyond the scope of the delegated authority or, more likely, are simply viewed as poor or unpopular policy at the time the veto is cast? If legislative power is to be exercised through rulemaking, why not make sure that ultimate power to approve or reject these rules rests with the elected members of Congress rather than the tens of thousands of unelected bureaucrats?

The logic became more compelling to many in Congress when Vietnam and Watergate spurred the desire to check the "imperial presidency." Congress has reasoned that its constitutional authority to appropriate all funds and to determine much of the nation's policy direction carries with it, under the "necessary and proper" clause of the Constitution, the power and duty to delegate the exercise of authority subject to the condition that one or both houses of Congress or its committees do not disagree with the way the authority is exercised. As Justice White pointed out in his dissent in *Chadha*, the legislative veto became, in the minds of many, not only efficient, convenient, and useful, but "an important if not indispensable political invention that allows the President and Congress to resolve major constitutional and policy differences, assures the accountability of independent regulatory agencies, and preserves Congress's control over lawmaking." The belief was (and is) widespread that, as Justice White also put it, the "complexity and size of the Federal Government's responsibilities [have] grown so greatly that the Congress must rely on the legislative veto as the most effective if not the only means to insure their role as the nation's lawmakers."

A Delicate Constitutional Balance

To many, however, the constitutional objections to the legislative veto are insurmountable and the practical advantages wholly illusory. The constitutional issues go to the very core of our system of government. First, the powers of the national government were quite deliberately divided among three branches because the concentration of governmental power was considered the greatest threat to individual liberty. In the view of the Framers, the accumulation of power in one branch of government was, as Madison expressed it, "the very definition of tyranny," and the legislature, with the authority to make all laws and to appropriate all money, was considered the branch with the greatest

In the view of the Framers, the accumulation of power in one branch of government was, as Madison expressed it, "the very definition of tyranny". . . .

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After the Legislative Veto

Reflections from the Losing Side

Michael Davidson

AMONG THE CASES the Office of Senate Legal Counsel inherited when it came into being in July 1979 was *Chadha* v. *Immigration and Naturalization Service*, a case that seemed to be hibernating in the Ninth Circuit Court of Appeals after having been argued there fifteen months earlier. The case came to life for us on December 22, 1980, when the circuit court held the one-house veto invalid under section 244 of the Immigration and Nationality Act of 1952. From then until the Supreme Court laid the issue to rest on June 23, 1983, the veto question commanded our attention. Writing just after that preoccupying experience, I offer here only a few preliminary personal observations.

There is no doubt about the completeness of the Court's invalidation of the legislative veto. The key to the breadth of the Court's opinion is its reliance on the presentment clauses. These are the clauses in Article I which provide that all bills and every resolution requiring the concurrence of both houses of Congress shall be presented to the President for signature or veto. The Court wove the presentment clause into a general statement about the separation of powers, but its emphasis on them demonstrates that their violation alone is sufficient to invalidate all vetoes by one or both houses. Both Justice Lewis Powell in his concurrence and Justice Byron White in his dissent perceived the sweep of the ruling. The Court's summary invalidation of vetoes under the Natural Gas Policy Act of 1978 and the Federal Trade Commission Improvements Act of 1980 confirmed these fraternal observations. In short order, the Court had applied the principles of *Chadha* to executive and independent agencies, and to unicameral and bicameral disapproval statutes.

IT MIGHT SOUND a little like Dr. Pangloss for a supporter of the losing side, like myself, to praise the decision. In looking at the totality of the loss of the legislative veto, however, I have found much to value in Chief Justice Warren Burger's majority opinion as well as in Justice White's dissent. Being not yet fully removed from my own affiliation with this case, I ask indulgence for starting with the dissent.

There has always been a great deal of strong language used in discussions about the legislative veto. It has been said that the device amounted to legislative tyranny and invited manipulation by special interests. But its history was far less dark. Congress used statutory authorizations for the veto to resolve important political difficulties at historic moments when the nation's well-being would have suffered from extended legislative impasses. The veto procedure was a means of assuring a concerned Congress that it could safely delegate

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the extraordinary powers the President would need to manage the economy and foreign affairs during World War II. It was used over thirty times in those four years. Subsequently, in the 1970s, Congress turned to the veto to resolve a number of severe disagreements between the political branches about the allocation of budgetary and foreign policy powers. Justice White's dissent recognized the intertwined purposes of the veto: to provide flexibility to the executive, to ensure that final accountability remains with elected representatives, and to furnish presidents and congresses with a means of resolving major differences. Without the veto some of these objectives may be subordinated. Nevertheless, finding a balance between flexibility and accountability remains the challenge to the political branches. The dissent stands as a durable statement of the problem that they must now address through some means other than the veto.

Although we had wishes for a different or at least a narrower majority opinion, still, if we had to lose as totally as we did, the chief justice's statement of basic principles served the occasion well. The breadth of the opinion took from us the chance to make the argument for the veto in what we thought were stronger cases, such as those involving statutes regulating impoundments, war powers, foreign arms sales, and nuclear fuel transfers. However, our plea for judicial prudence may have been overcome by judicial realism. If the question of the legislative veto could be answered by reference to constitutionally invariable procedures, then the full answer could be given in one case. The wide reach of the Court's opinion potentially creates a large immediate repair problem for the Congress. Yet, there is a good reason—as much as we argued against it—to prefer an immediate answer to a prolonged period of statute-by-statute litigation.

The legislative veto has served, as noted, to reconcile intense political differences of the past; with the passage of time many of those disagreements might now be resolved through other arrangements. There is no fixed reason, for example, why it should now be necessary to keep the legislative veto in the immigration laws, even though it was a useful means of distributing power during an earlier impasse. In fact, the Judiciary committees in both houses reported bills in 1980 to repeal the immigration vetoes. The greater value of the legislative veto may always have been its usefulness in resolving new problems, serving as a temporary accommodation during stressful times, until a more lasting equilibrium between the political branches could be developed. This suggests that the truly serious loss may be the unavailability of the veto in resolving presently unforeseen problems. Nevertheless, the wisdom of the Court's decision, as I perceive it, is that the elective branches should know how constitutionally secure their new compromises will be. The chief justice's opinion marks those boundaries clearly.

THE IMMEDIATE QUESTION for Congress is whether existing statutory arrangements will have to be repaired. This question turns in large part, initially, on the severability of statutes that contain legislative veto provisions. In other words, is the delegation of power to the executive or an agency severable from the congressional check on that power, the veto? If not, the delegation falls with the veto.

We presented this as a major consideration, important in its own right, in *Chadha* and in the companion case under the Natural Gas Policy Act. In *Chadha*, the Court found that the presence of a severability clause created a presumption of severability that could not be overcome. In the Natural Gas Policy Act case, the absence of a severability clause did not deter the Court from affirming a judgment of severability. Putting these decisions together, there is hardly a case in which the courts will rule that delegated executive power is completely bound up with the veto that had superintended it. The result is that the executive emerges after these long years with the better part of a fifty-year bargain. The burden will be on Congress to recapture any power it believes it has lost.

This is not to say that severability is inimical to Congress in all cases. The impoundment portions of the Congressional Budget and Impoundment Control Act of 1974 were a compromise between divergent House and Senate approaches. The Senate position was that the President should be required to obtain specific statutory authorization if he wished not to expend appropriated funds. The House approached the matter differently. Reluctant to require congressional action to authorize every

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presidential refusal to spend, it preferred a statute that would enable the two houses to select which presidential refusals they would override and to allow all others to become effective by congressional silence.

The final compromise conformed substantially to the Senate's view. If the President cannot get both houses to pass a rescission bill within forty-five days of requesting it, then the appropriated funds must be expended. Thus the rescission of an appropriation, which amounts to the permanent modification of an appropriation law, requires a new law, a result that is fully consistent with *Chadha*. The veto portion of the impoundment act applies only to temporary deferrals of spending within a fiscal year. For cases when the President postpones spending, but does not cancel it, Congress adopted the House plan of selective consideration by each house of proposed deferrals. Under the test of severability, the rescission mechanism stands independently of these deferral procedures. Even if the power to disapprove deferrals is severable from the power to make them, the power of the executive remains sharply limited, since all it can use its power for is to delay the inevitable. The executive has gained more flexibility over the timing of expenditures within fiscal years, but it is not relieved of its obligation ultimately to honor congressional spending determinations.

The preceding short narrative on impoundment controls provides a side lesson of some significance. While the veto has been viewed as a means of reconciling executive and legislative differences, it is naturally a mistake to think of Congress as a monolith. Frequently the veto has been a tool of bicameralism to reconcile the differences between the two houses of Congress. In these cases, the severance of legislative veto provisions will push the statute closer to the original legislative proposal of one house or the other and undo the compromise that had allowed the houses to agree. The unavailability of the veto in the future may make some compromises within Congress more difficult to attain.

ASIDE FROM WHETHER AND HOW to repair existing statutes, the major issue for Congress is whether to search for new mechanisms or to adapt old ones to achieve the objectives of the veto. The beginning point for this search should be the recognition that the legislative veto was a procedure to resolve many different kinds of issues. Now that the common solution that unified these issues—the veto—has been removed, the differences among them become important in assessing what, if anything, should replace the veto.

The subjects to which the device has been applied may be assigned to two rough categories. In one category are those problems for which it would be difficult and perhaps undesirable for Congress to delineate detailed standards for executive action in advance. Often the executive actions involved are those that are taken directly by the President. Examples are arms sales and executive reorganization plans, in which the President's determinations will be shaped by events in contexts not foreseen by the original delegation of authority. The veto supplied a needed procedure for assessing particular decisions that Congress could not have easily anticipated ahead of time and addressed in a general statute. Consequently, the interest of Congress in controlling executive discretion in such matters cannot be fully satisfied by setting clearer standards for the agencies. For this reason, the search for alternatives to the veto, especially in the area of foreign policy, may very well include procedures which require that Congress be a participant in those singular decisions.

Rulemaking is different because there is no reason to doubt that Congress is able to prescribe more explicit standards for rulemakers. Granted, the application of developing scientific knowledge in, for example, environmental regulation can also involve an assessment of the new and the unpredictable. Nevertheless, the constitutional legitimacy of rulemaking requires that agency decisions should be made according to a consistent set of legislated principles. The impetus behind the veto of agency rulemaking came from the difficulty of attaining that goal, not from a doubt of its importance or validity. It also came from a desire for an auxiliary way to ensure adherence to congressional intent and, in some instances, a desire for an opportunity to reexamine particular delegations to rulemaking bodies. Perhaps the greatest weakness in our argument for the veto was our inability to explain why the first of these objectives did not involve a

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judicial act, and why the second was not an attempt to amend statutes by a means other than new legislation.

THERE ARE A NUMBER OF ALTERNATIVES already in the field and ready to compete for legislative favor. One is a proposal to assign to the President the responsibility for monitoring the rulemaking activities of both executive and independent agencies. Several years ago, the American Bar Association appointed a Commission on Law and the Economy to study federal regulatory agencies. The commission looked for a means to harmonize the potentially conflicting objectives of regulatory agencies and recommended, in a 1979 report, that the President be authorized by statute to direct agencies to consider or reconsider the issuance of critical regulations. Other alternatives would leave the controlling influence in the legislative branch. Congress could identify those regulatory activities that engender the greatest concern about the proper role of administrative agencies in a democracy, and provide a further statutory delineation of the authority of those agencies. Or Congress could use its legislative power to review specific administrative actions through a constitutional form of legislative review that involves both houses of Congress and the President.

One proposal to implement this last alternative is simply to substitute joint resolutions of disapproval for unconstitutional legislative vetoes. The constitutional infirmity of one- or two-house vetoes of rules is not shared by statutory disapproval of agency rulemaking. There is a good reason to pause before settling for only that, however—and it is that Congress may have more flexible tools at hand. To see why, we should revert for a moment to the structure of the legislative veto and the practical problem it created.

The typical legislative veto statute was organized around three central features: that the agency report a proposed rule or action to Congress, that the effective date of the rule or action be deferred until after a period of congressional review, and that the resolution before Congress be in a prescribed and generally negative form. These statutes were often embellished by procedures for expedited congressional consideration, particularly special rules to hasten committee discharge of veto resolutions and limitations on debate.

Of the three features, the key to the veto procedure was the prescribed negative resolution of disapproval. This resolution was unamendable and it disapproved the entire agency action. The reason for its fixed form lay in the constitutional uncertainty that always hovered over the legislative veto. Even the strongest advocates of the veto recognized that Congress could not reserve the right to reshape an executive proposal. The constitutionality of the veto, everyone agreed, required that the agency proposal be accepted or rejected by a resolution in the form prescribed in the veto statute. If Congress had attempted to go beyond the form prescribed in the veto statute, it would have been engaging in legislation. The negative form of congressional action was never wholly satisfactory because it failed to inform the agency, in a positive fashion, how it should exercise its discretion. There was simply no choice, however, because anything that varied from the statutorily prescribed form of the veto would require new legislation.

This is the silver lining of Chadha: while fixed procedures and a limited question were "inseverable" from the legislative veto, Congress is now free to choose from a wider range of alternatives in erecting a replacement.

If Congress is to adopt statutory resolutions of disapproval, however, it can easily go on to provide substantive guidance to the agency at the same time. In fact, Congress has done this for years in its consideration of rules of civil and criminal procedure which have been prescribed by the Supreme Court and submitted to Congress for review. There is absolutely no cause for constitutional concern if Congress turns its review of selected agency rules into an occasion to act affirmatively about them. This is the silver lining of *Chadha*: while fixed procedures and a limited question were "inseverable" from the legislative veto, Congress is now free to choose from a wider range of alternatives in erecting a replacement. ■

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Restoring the Separation of Powers
Theodore B. Olson
(Continued from page 22)

potential power. The Framers also believed, along with Montesquieu, that "there can be no liberty where the legislative and executive powers are united in the same person, or body of magistrates." Hence, Madison cautioned, "it is against the enterprising ambition" of the legislature "that the people ought to indulge all their jealousy and exhaust all their precautions."

Not only did the Founders believe that vesting executive power in the legislature would lead to tyranny, but they also generally agreed that a great legislative body must set policy. Involving itself in the details of enforcing the law would quickly destroy the legislature's ability to make policy. In a letter in August 1787 regarding the proposed structure of the national government, Jefferson put it this way:

> Nothing is so embarrassing nor so mischievous in a great assembly as the details of execution. The smallest trifle of that kind occupies as long as the most important act of legislation and takes the place of everything else. Let any man recollect or look over the files of Congress, he will observe the most important propositions hanging over from week to week and month to month, till the occasions have past them, and the thing never done. I have ever viewed the executive details as the greatest cause of evil to us, because they in fact place us as if we had no federal head, by diverting the attention of that head from great to small objects.

The second basic premise of our constitutional structure that is brought into question by legislative vetoes is the President's role in the legislative process. There was virtual unanimity at the Constitutional Convention that the President should participate in that process by exercising a veto over proposed legislation. The purpose was threefold:

- To check, as Chief Justice Burger put it in *Chadha,* "whatever propensity a particular Congress might have to enact oppressive, improvident, or ill-considered measures."
- To ensure that the legislative process included a national perspective. As expressed fifty years earlier by the Supreme Court in *Myers* v. *United States* and again in *Chadha*: "The President is a representative of the people just as the members of the Senate and of the House are, and it may be, at some times, on some subjects, that the President elected by all the people is rather more representative of them all than are the members of either body of the Legislature whose constituencies are local and not countrywide. . . ."
- To enable the President to defend the powers of the executive from legislative encroachments. Without the veto, Hamilton observed, the "legislative and executive powers might speedily come to be blended in the same hands" and the President, "absolutely unable to defend himself against the depredations" of the legislature, "might gradually be stripped of his authorities by successive resolutions, or annihilated by a single vote."

The third fundamental structural component of the Constitution violated by many legislative vetoes is bicameralism. Hamilton, among others, regarded the prospect of a single legislative chamber so abhorrent that he declared that the result would be the accumulation, "in a single body, [of] all the most important prerogatives of sovereignty, and [would] thus entail upon our posterity one of the most execrable forms of government that human infatuation ever contrived." The internal check of two chambers, each elected in a different manner and each to provide representation from a different perspective, was extraordinarily important to the Framers.

The presentment clauses of the Constitution bring these principles together. Article I, section 7, clause 2, plainly states that federal laws are made in the United States only by the affirmative votes in two houses of Congress in favor of a bill followed by submission to the President for his approval or veto and, if vetoed, overridden by a two-thirds vote in both houses. Anticipating that if this requirement were confined to bills, it could be evaded "by acts under the form and name of resolutions," the Framers added clause 3. That clause provides that "[e]very Order, Resolution, or Vote" requiring concurrent action (except resolutions of adjournment) "shall be presented to the President," who may approve or veto the order, resolution, or vote. Like clause 2, clause 3 provides that a vetoed bill may still become law if it is subsequently passed by a two-thirds

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vote of both houses of Congress. Thus, clause 3, read in conjunction with clause 2, makes quite plain that the Framers intended that *all* exercises of legislative power having the substantive effects of legislation must follow the specified legislative procedure, irrespective of the form of congressional action.

While skillful arguments were made in support of the constitutionality of legislative vetoes, it is difficult to imagine a concept that would more squarely contravene three such vital structural components of the Constitution —separation of powers, checks and balances, and bicameralism. Not including Justices Powell and Rehnquist, who would have approached the matter differently, a total of nineteen federal court of appeals judges and Supreme Court justices considered the constitutionality of legislative vetoes in the development of the three cases that the Supreme Court finally decided in late June and early July. In several broad and unequivocal opinions, all relying more or less on the same constitutional principles mentioned here, eighteen of the nineteen came to the same conclusion: legislative vetoes are fundamentally and unquestionably antithetical to the text, structure, and basic tenets of our national charter.

In *Chadha*, the Supreme Court determined that *every* legislative act taken by Congress had to comport with the presentment clauses. And it defined legislative acts broadly to include all actions that have the "purpose and effect of altering the legal rights, duties and relations of persons including Executive Branch officials . . . outside the Legislative Branch."

Aside from constitutional objections, there are practical objections to the veto device. Widely respected observers have provided compelling testimony that legislative vetoes simply did not serve the purposes for which they were intended, and were, in fact, counterproductive. A distinguished American Bar Association Commission on Law and the Economy found them "inefficient and not very helpful" ("Federal Regulation: Roads to Reform," 1979). The commission's report added: "Unlike the normal process of legislative amendment, legislative vetoes totally destroy the rules as promulgated, put nothing in their place, and leave the agency in a quandary as to what if anything it should do next to fulfill its statutory mandate."

Former assistant attorney general and University of Chicago law professor Antonin Scalia, now a federal appeals court judge, set out a devastating indictment of the practical effect of legislative vetoes in these pages four years ago ("The Legislative Veto: A False Remedy for System Overload," November/December 1979). He and others have demonstrated that rather than fostering more participation in the policy-making process by members of Congress, legislative vetoes do exactly the opposite in a variety of ways. In the first place, they give Congress a convenient, perhaps subliminal, excuse for excessive, overly broad delegations of authority. It is much easier to justify broad grants of authority with the rationalization that specific exercises of delegated authority will be reviewable.

Second, legislative vetoes foster nonaccountable decision making and allow lawmakers to evade politically tough decisions. As Judge Scalia observed, broad, safe, and unimpeachable platitudes such as "safe and healthy" places to work, products free of "unreasonable risks of injury," and freedom from "sex discrimination" are placed on the legislative agenda and approved, while the genuinely political task of converting these ideals into hard policy choices are left to unelected decision makers. Lawmakers may criticize an unpopular decision by an "unelected bureaucrat" without ever having to cast, and therefore defend, an affirmative vote on the subject.

They also tend to bog Congress down in precisely the minutiae about which Jefferson cautioned. When every agency decision, however insignificant, is reviewable, Congress will find itself hopelessly mired in trivia and unable to expend its precious human resources on the larger issues involved in giving policy direction to the country. Moreover, instead of increasing the involvement of elected officials in decision making, the practical effect of legislative vetoes is to impose an additional bureaucracy consisting of committee and subcommittee staffs over the existing agency bureaucracy. As a result, the process becomes even more mysterious and Kafkaesque, intelligible only to the lobbyists. Finally, the legislative veto mechanism may undermine respect for the rule of law in that Congress may appear to use it in an arbitrary and capricious manner. The House voted to compel Mr. Chadha's deportation without de-

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bate or recorded vote. And the House's veto of the Federal Energy Regulatory Commission's incremental pricing rule for natural gas (overturned by the Supreme Court two weeks after *Chadha*) seems to have been a case of changed sentiment: the same body, just two years before, had passed the law requiring such a rule.

The legislative veto, then, was due for reappraisal even if the Supreme Court had upheld it. Now that it has been struck down, both the courts and Congress will have major decisions to make. For the courts, the task is the more limited one of tying up loose ends. The *Chadha* Court decided that the legislative veto in that case was severable from the authority granted the attorney general. Hence, the attorney general may continue to suspend deportations in appropriate cases and there is little likelihood of litigation over past acts under that provision. However, suits over future exercises of authority under other statutes with legislative veto provisions may be initiated on the theory that the unconstitutional segment may not be severed from the grant of authority. If not, the substantive authority might fall along with the unconstitutional feature. While the Court's legislative veto decisions strongly suggest that most veto provisions will be found to be surgically removable without damage to the residual authority, that result is by no means automatic. Each statute will have to be examined individually.

Retroactivity might also be an issue for the courts. To what extent may authority be exercised if it was initially transferred by the President from one agency to another pursuant to a reorganization statute with a legislative veto? While the courts may not wish to upset settled decisions or the allocation of authority which has existed for many years, imaginative lawyers will almost certainly develop arguments to the contrary.

Congress, meanwhile, will have the more open-ended responsibility of deciding what it should do, if anything, to replace the authority that it granted to itself and to its committees through legislative vetoes. Many constitutional alternatives are already being debated. In organic statutes, Congress can—and undoubtedly should—place more specific and precise limits on agency authority to issue rules, particularly in areas having major policy implications. Many broad delegations of power have been on the books long enough to provide a base of experience from which Congress can derive more exact and detailed statutory guidance.

Congress can always override unwise, inappropriate, burdensome, or excessive agency rules with legislation. After all, the only difference between an unconstitutional concurrent veto resolution and a valid joint resolution is that the President is included in the latter process. The President is not likely to disagree with both houses often, and he must pay a political price if he does. Some argue that timely congressional responses to agency actions will be difficult because of the procedural hurdles within Congress that impede the enactment of legislation. However, Congress can adopt rules ensuring early floor consideration of bills overturning agency regulations. This technique, of course, suffers from the same criticism that the ABA commission leveled against legislative vetoes: it is not particularly constructive simply to overrule a regulation if nothing is put in its place.

Congress can also adopt sunset provisions that require agencies to return to Congress periodically for reenactment of generic authority. Congress can hold oversight hearings, at which members of Congress may demand explanations for rules perceived to be frivolous or excessive. Congress can adopt resolutions expressing views which may not be legally binding upon an agency, but which may be useful from a policy standpoint in an agency's implementation of the law. "Report-and-wait" provisions, pursuant to which agencies must give Congress an opportunity to respond through legislation before rules become effective, suffer the defect of prolonging important rulemaking, often unnecessarily. But they may be useful in some situations and are certainly constitutional.

Congress, of course, has the authority to appropriate the funds with which agencies execute the law. Encumbering appropriations measures with substantive legislation is a most unfortunate process because it mingles policy judgments with budgetary considerations and circumvents the committee deliberations that are so vital to sensible substantive enactments. However, it is a constitutionally sound congressional technique and Congress may choose to employ it in certain select, but one would hope limited, situations.

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The alarmists who have been bemoaning the *Chadha* decision seem to have little faith in the Constitution. Justice White's dissenting opinion suggested that Congress would be faced with the dilemma of having "either to refrain from delegating necessary authority, [therefore] leaving itself with a hopeless task of writing laws with requisite specificity . . . , [or to] abdicate its law-making function to the executive branch and independent agencies." However, it is by no means obvious that government has become so complex in the last few years that writing reasonably specific delegations of authority has become "hopeless." Nor is it evident that including in the process the one official elected by the nation as a whole, exactly as contemplated by the Constitution, has suddenly become impossible or unpalatable.

Justice White's dissent in the two legislative veto cases which extended *Chadha* to one- and two-house vetoes over independent agency rulemaking made the telling point that the "President's authority to control independent agency law-making . . . on a day-to-day basis is non-existent." He argued that the invalidation of the legislative veto removes congressional control as well, which "merely guarantees that the independent agencies, once created, for all practical purposes are a fourth branch of the government not subject to the direct control of either Congress or the executive branch." This question of accountability is a valid and vital one, but Justice White seems quite wide of the mark when he implies that *Chadha* means that an unaccountable fourth branch is a constitutional command. The legislative veto was neither an effective nor constitutional answer to the real problem of an unaccountable fourth branch. It is time to develop more congressional direction in the guidance given to these agencies and to put responsibility for the faithful execution of the law back where it belongs—in the executive branch, under the President who the people elected to fill precisely that role.

Restoring Accountability

Each time an apparent need in our society is addressed by a branch of government neither created for nor equipped to handle the task, the consequences prove to be regrettable in the long run. The courts tend to lose both the support of the governed and their capacity to decide cases expeditiously as they venture more into the legislative and executive arenas to fulfill perceived lapses by the other branches. The same is true of the other branches—their capacity to perform the functions assigned to them atrophies and their credibility and acceptability as instruments of government decrease as they plunge more of their limited resources into responsibilities allocated to other branches.

Each time an apparent need in our society is addressed by a branch of government neither created for nor equipped to handle the task, the consequences prove to be regrettable in the long run.

We have witnessed an increasing tendency in recent decades not to trust the existing institutions of our government to solve society's ills. One consequence has been resort to a mixed assortment of commissions, agencies, government or quasi-government corporations, authorities, institutions, and boards. They collectively form the "fourth branch" to which Justice White referred, but they are not cohesive, centrally managed, or accountable in any intelligible way to specific governmental authority, and are barely understandable to the vast majority of Americans. It is legitimate and timely, especially in the aftermath of *Chadha*, to ask whether these entities produce what we expect of them or whether they are simply self-perpetuating and unchecked baronies. Perhaps some of the energy that we will undoubtedly expend in seeking alternatives to legislative vetoes should be channeled into efforts to return authority to the three branches of government carefully established by the Framers of the Constitution. As a beneficial byproduct, the process might expose authority that is not only lodged at random in various unrestrainable agencies, but is not even the proper business of the federal government. The primary result, however, should be the rediscovery that in our system power must be exercised in a manner that allows the electorate to hold its representatives to account for decisions employing that power. ■

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Toward Competition in Phone Service

Why Local Rates Are Rising

Leland L. Johnson

MORE THAN A DECADE AGO, the Federal Communications Commission (FCC) opened the door to competition in long-distance telephone service by permitting MCI and other carriers to compete in some markets. Ever since, controversy has raged about the effects of that action on telephone subscribers (especially residential) and on the national goal of ensuring "universal" telephone service. AT&T's coming divestiture of its twenty-two Bell operating companies, scheduled for January 1, 1984, has only brought the matter to a head.

In recent months, both the House and the Senate have held hearings in response to widely voiced fears that local telephone rates are going to double or triple in the next few years (over and above general inflation)—possibly forcing many residential subscribers to discontinue service. Fourteen bills designed to keep that from happening are now before Congress, with more on the way. Other initiatives are in the works in the states. (For a brief description of these bills—as well as of the costing and pricing of phone service, before and after January 1, 1984—see page 34.)

That rates will rise is clear enough. For some years AT&T's prices for long-distance calls have been set above cost in order to help keep prices for local calls below cost. That is, local service has been subsidized. Under the FCC's recent access charge ruling (on which, more later), this subsidy is to be gradually replaced by charges imposed directly on telephone subscribers. If that ruling goes into effect on schedule, local phone bills will begin to rise next year.

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What Is the Problem?

Many are asking why the traditional subsidy is being reduced. Some blame the AT&T divestiture. As a case in point, Moody's explained its recent downgrading of the Bell System's bonds by noting in part that, at divestiture, the local telephone companies will lose highly profitable long-distance facilities to AT&T. Yet the nation's nearly 1,500 *independent* telephone companies have been able to offer low local rates

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for decades without owning much in the way of long-distance facilities and without themselves being owned by AT&T. The reason is that they have been receiving financial support through "settlements," the process by which AT&T pays them for handling the local-exchange ends of long-distance traffic. Surely, the newly divested companies could demand similar arrangements.

. . . the fundamental problem is that . . . . long-distance carriers can use satellites and other advanced means to connect their large customers, thus bypassing local telephone lines altogether.

No, the fundamental problem is that new technologies are eroding the local monopolies of both the Bell telephone companies and the independents over access to the local subscriber. Increasingly, long-distance carriers can use satellites and other advanced means to connect their large customers, thus bypassing local telephone lines altogether. No one knows how fast bypass will develop. What is clear is that if it occurs on a significant scale, the resulting revenue loss to the local companies would force them to raise rates for their remaining customers—unless, of course, countervailing regulatory or legislative action were taken.

Some large telecommunications users are already bypassing telephone networks—both local and long-distance—using satellites, land-based microwave stations, private (coaxial or fiber optic) cable lines, and other technologies. For example, Satellite Business Systems offers nationwide high-speed data transmission and other services using satellites that communicate with antennas located on its customers' premises. A number of organizations, including hotels in Atlantic City and Las Vegas, use microwave lines to bypass local telephone networks. At least one business firm uses a combination of satellite links and its own fiber optic cable to carry on video conferencing among its scattered locations. New York City leases channels from a local cable TV system to provide high-speed data communications, and has requested proposals for a network to connect city offices, police stations, and firehouses throughout its five boroughs. Finally, increasingly ambitious "local area networks" are being developed to provide communications within a building or cluster of buildings.

While it is most unlikely that telecommunications firms will ever be able to compete across the board with the local telephone companies, they will unquestionably be able to compete on a selective basis for the largest users. Today 1 percent of the nation's business phone customers account for about 40 percent of business interstate message toll revenues. If even a fraction of these heavy users bypass the local companies, it could badly undercut the present rate structure.

The erosion of the local telephone monopoly is responsible for two particularly important developments. First, anticipating the competition to come, companies are accelerating the write-off of their capital assets to reflect current economic value, rather than their remaining physical life. Accelerated depreciation raises rates in the near term, but contributes to lower rates in later years. Thus, the problems posed by the change, while serious, are transitory. Second, facing the threat of bypass, these companies are less able to extract from long-distance users the large subsidies that today help to keep local rates down. This article focuses on the second of these developments because issues of whether and how to maintain low local rates are being widely debated and because the outcome of the debate will affect the long-term efficiency of our telephone system.

. . . economic inefficiencies arise if long-distance carriers have to pay such high rates for access to local lines that they resort to bypass systems even when the cost of connecting their subscribers that way exceeds the cost to the local phone companies of providing the access.

The Threat of Uneconomic Bypass

In principle, there can be little objection if long-distance users take advantage of lower-cost alternatives to telephone lines. But economic inefficiencies arise if long-distance carriers have

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to pay such high rates for access to local lines that they resort to bypass systems even when the cost of connecting their subscribers that way exceeds the cost to local phone companies of providing the access.

To understand the problem of uneconomic bypass, it is helpful to look briefly at how telephone costs and long-distance revenues are divided between the interstate and intrastate jurisdictions. Under procedures instituted in 1943, the annual costs of facilities used only for interstate calls, along with part of the costs of facilities that are used for both interstate and intrastate calls, are assigned to the interstate jurisdiction and are covered from revenues on interstate service. This leaves only a portion of the joint costs to be covered from intrastate revenues. After World War II rapid advances in coaxial cable and microwave radio technology radically lowered the per-circuit costs of long-distance transmission, but had much less effect on the cost of local exchange equipment. State regulators, having jurisdiction over intrastate operations and facing political pressures from local voters, naturally wanted some of the cost savings to be passed back to local users—especially residential—through lower monthly rates. The FCC, having jurisdiction over interstate service and being one step removed from local pressures, thought the benefits of long-distance technology should flow to long-distance users through lower toll rates. As a result of the push and tug, the FCC and the state regulators have agreed to change the cost separations formula many times, always increasing the interstate contribution to help cover intrastate costs.

Among these intrastate costs are the costs of the local "subscriber lines" required for end-to-end connections. Subscriber lines include the telephones in residences and businesses, the wires that connect the telephones to local switching centers, and the connections in these centers. Because these lines are required for access to both the local and the nationwide network, the cost of maintaining and replacing them can be considered the cost of subscriber "access," separate from the costs of either local or long-distance calls. In 1981, according to AT&T, about 38 percent of the interstate revenues from ordinary long-distance service and wide-area telephone service (WATS)—more than $7 billion annually—went toward covering the cost of subscriber access. The $7 billion translates to about $7 a month, as a nationwide average, per subscriber line.

The problem of uneconomic bypass arises because the subscriber-line costs assigned to the interstate jurisdiction are recovered on a usage basis (at an average rate of about 14 cents per message minute), even though the cost of subscriber lines does not vary with usage. The resulting distortion creates incentives for inefficient behavior. For example, a business firm that makes 200 interstate calls a month of five minutes each can expect to pay $140 a month if it uses regular subscriber lines to do so. If the firm can find a way to make end-to-end connections for less than $140, it comes out ahead. But the price it pays for the alternative, though less than $140, might be far greater than what it costs the local telephone company to provide access. Society loses by the difference. The more calls the firm makes, the greater its incentive to seek bypass, and the greater the chances that the cost of the alternative it picks will exceed the access costs to the telephone company. This source of economic inefficiency would be eliminated if the usage charges on long-distance services were replaced with flat charges (not varying with use) paid by subscribers directly.

The Regulators' Dilemma

That is what the FCC's access charge plan is designed to accomplish. Under that plan, subscriber line costs assigned to the interstate jurisdiction are to be recovered by gradually substituting—over a six-year period starting January 1984—flat subscriber-access charges for usage charges on interstate traffic. As the burden on interstate service is shifted to local service, long-distance rates are expected to fall. Thus, heavy long-distance users will gain, while those making few such calls will lose. The FCC's ruling also creates a new universal service fund, to be supported by charges on interstate carriers in proportion to their use of local telephone facilities. The fund will help support service by local telephone companies whose costs for providing subscriber lines are particularly high.

The FCC's order created so much controversy when it was issued in December that the commission modified it in July, primarily by setting the rates a bit lower and phasing them in

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How the Money Circulates

Telephone costing and pricing is confusing partly because the geographic bounds that separate levels of service from each other are different from those that separate the operating reach of the various companies and the two levels of regulatory jurisdictions. (1) Local calls are those made within an exchange area; long-distance calls, also known as toll calls, are those made from one exchange area to another. (2) Local service is provided by local operating companies, consisting of the twenty-two Bell companies and some 1,500 independents; long-distance service has traditionally been provided by AT&T's Long Lines division, by the Bell companies, and to a small degree by some independents. (3) The Federal Communications Commission regulates interstate long-distance operations, while state commissions regulate intrastate operations.

Thus a call originates and terminates with either a Bell or an independent phone company, and is either a local call (intra-exchange) or a long-distance call (inter-exchange—which can be either intrastate or interstate). The originating company bills the caller for the total amount and gives part of it to the other companies involved.

Today's System

Three procedures have evolved for allocating costs and revenues among the parts of this network:

Separations is a procedure devised by federal and state regulators to divide costs between the federal and state jurisdictions so as to establish how much consumers will be charged in each jurisdiction. Because local equipment is used in making long-distance as well as local calls, this procedure assigns a share of its cost to the federal jurisdiction. Some of the costs involved are traffic-sensitive (primarily switches and trunks) and others are not (primarily the wires connecting each subscriber to the local exchange). Under the complicated, but ultimately political, formula used for dividing these costs, the share assigned to the federal jurisdiction has risen over the years.

Settlements is a procedure that allocates long-distance revenues, nearly all of which are earned by AT&T Long Lines, between AT&T Long Lines and the independent phone companies. It is meant to pay for AT&T's use of the independent companies' facilities. *Division of revenues* is an internal Bell System procedure that channels payments from AT&T Long Lines to the Bell operating companies. It serves the same function as settlements.

In the 1970s, such firms as MCI emerged to compete with the traditional long-distance network. The new firms built their own long-distance facilities and initially rented local lines at regular business rates (now about $20 per month) in order to pick up and deliver their customers' calls. AT&T wanted the competitors to pay higher rates, equivalent to what it was paying through separations, settlements, and division of revenues. The competitors responded that the lines they were using were ordinary business lines and that these "line-side" connections were distinctly inferior to the "trunk-side" connections AT&T was getting. Negotiations between the Bell System companies and the competitors finally led in 1978 to the ENFIA tariff (Exchange Network Facilities for Interstate Access), under which the competitive carriers now pay about $230 per line per month for business lines.

The System after January 1, 1984

The AT&T antitrust settlement and the FCC's access charge ruling, which go into effect on January 1, 1984, mandate changes in the traditional system.

First, the court order codifying the settlement requires the local phone companies to make access of equal quality available to every long-distance carrier by 1987. Second, both the court order and the FCC's access charge ruling—discarding settlements, division of revenues, and the ENFIA tariff—require the local companies to charge long-distance carriers cost-based rates for access to local subscribers. For its superior connection, AT&T will pay a premium until equal access is achieved.

Third, the FCC's ruling also requires the local companies to charge subscribers a flat rate for access to the network, as follows: for residential users, a maximum of $2 a month in 1984, rising to $3 in 1985 and $4 in 1986, and then to full cost (estimated at $6–8) by 1989; for business users, a maximum of $6 a month in 1984 and full cost by 1989. These charges are intended to shift all costs that are not traffic-sensitive to end users—subscribers. The overall effect will be to lower long-distance rates and raise local rates.

Because of concerns about rising local rates, the FCC decided to phase in the subscriber charges over six years and to create a universal service fund paid for by the long-distance carriers to assist high-cost areas (such as Wyoming and Alaska). In addition, Congress has before it fourteen bills that seek to prevent or moderate the rise in local rates. The apparent frontrunners are H.R. 3621 (Reps. John Dingell, D-Mich., and Timothy Wirth, (D-Colo.) and S. 1660 (Sen. Robert Packwood, R-Oregon). These bills would replace the FCC's subscriber access charges with new charges on long-distance systems and would set them high enough to cover all non-traffic-sensitive costs assigned to the federal jurisdiction, now estimated at $11 billion. More modest bills, H.R. 3647 (Rep. Edward Markey, D-Mass.) and H.R. 3671 (Rep. Robert Whittaker, R-Kansas), would keep the FCC's plan but stretch out the transition to ten years.

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over six years rather than five. That action has not mollified congressional fears. The Packwood and the Dingell-Wirth bills would undo the order completely and cope with the bypass problem by authorizing local telephone companies to assess charges on any carrier that uses alternatives to their lines.

Whatever the fate of the FCC's plan for interstate services, there will remain similar problems at the intrastate level. Subscriber line costs are also covered in part by usage charges on long-distance calls within a state, once again raising the possibility of uneconomic bypass. In response, state regulators and telephone companies are considering charges for access to the intrastate network. Bell of Pennsylvania, for example, has proposed to the state Public Utility Commission an intrastate access charge of $2 a month for residential customers and $4 per line for business users, to be accompanied by a 25 percent reduction in intrastate long-distance rates.

All this poses a serious dilemma for the FCC and the state regulatory commission. On the one hand, the beneficiaries of the current system—local phone companies and the residential users who make or receive few long-distance calls—strongly oppose requiring subscribers to pay access charges. Access rates will rise to unreasonably high levels, they say, and some current users will have to give up service. Moreover, the regulators will face considerable political heat if, after a time, the bypass threat turns out to have been exaggerated. On the other hand, defenders of the plan point out that if the subsidy is continued and widespread bypass does occur, the revenues of the local companies will drop by so much that their remaining subscribers could be even worse off than with an access charge. And once bypass facilities are built, these companies will be hard put to retrieve many of their lost customers by making belated adjustments in their rate structures.

... defenders of the [FCC's] plan point out that if the subsidy is continued and widespread bypass does occur, the revenues of the local companies will drop by so much that their remaining subscribers could be even worse off....

Subsidizing Residential Access

Subsidization of residential access to the network reflects a long-standing national policy of encouraging widespread telephone use, in keeping with the aim of the 1934 Communications Act "to make available, so far as possible, to all people of the United States a rapid, efficient nationwide and worldwide radio and communications service." The underlying idea is that the value of the network to each subscriber increases as the size of the network expands and subscribers are able to reach more people in more places. This increase in value, called "network externalities," is said to benefit, on balance, even those who pay the subsidies.

How big is the difference between what subscribers now pay for access and what it costs the local companies to provide that access? The average subscriber line cost for the Bell System was about $26 a month in 1981, according to AT&T, and was increasing.* Residential telephone rates for access averaged less than $10 a month. Of the $16 difference, about $7 came from the $7 billion contributed by interstate services, and the remaining $9 was covered by intrastate services.

Not surprisingly, there are wide variations around these averages from state to state. For example, in Nevada and Wyoming subscriber line costs were $42 and $45 a month respectively in 1981, as against the $26 national average, and interstate services contributed $27 and $25 a month respectively to those costs, as against the $7 national average.

To be sure, these line cost figures reflect average historical costs, while the relevant economic cost is the current cost of connecting an additional subscriber. However, given the relatively low rate of technological progress in residential subscriber lines in recent decades, there is no reason to believe that incremental costs are below the Bell System's historical average of $26. Indeed, they may be higher than $26 because of the rapid inflation that has occurred since many of the existing lines were built.

*This figure reflects the combined average of both business and residential lines, but there is no evidence that the average cost of residential subscriber lines is substantially different.

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Thus, residential access is subsidized in the sense that, as a group, these users pay less—apparently much less—than their incremental costs. The subsidy is paid by users of other interstate and intrastate services.

In addition to the problem of bypass, the subsidy creates a number of other difficulties:

- The subsidy is untargeted, benefiting both the rich and the poor, and therefore is an inefficient way to keep on the network those who would otherwise drop off. As a case in point, the author, who pays only $4.10 a month for access, has often wondered about the social justification for his good fortune at the expense of others—including those among the poor who make lots of long-distance calls.
- Some argue that untargeted subsidies were justified in earlier decades in order to stimulate the development of a strong nationwide network. But today, when more than 95 percent of the nation's households have telephones, a universal service fund carefully targeted to the highest cost areas may be sufficient to maintain universal service. Fortunately, there are relatively few subscribers in high-cost areas. In 1980, for example, Nevada, Wyoming, and Alaska together contained less than 0.8 percent of the nation's residential telephones.
- Since the current system forces long-distance users to pay prices that exceed the cost of serving them, those users make fewer calls than they would if prices matched costs. A 1978 study by the National Telecommunications and Information Administration concluded that the social loss resulting from this uneconomic reduction in interstate calls runs to about $1.7 billion annually.
- Moreover, subsidization may encourage local phone companies to operate inefficiently. The larger their local costs, the more they receive in payments from outside sources—a relationship that lowers their incentive to minimize cost. This inefficiency, together with the uneconomic reduction in long-distance traffic, calls into question the wisdom of maintaining the subsidy even if bypass were not a threat.
- On the local level, business rates generally are markedly higher than residential rates, perhaps even high enough in some areas to supply part of the subsidy to residential access. The reason for the high rates is that business firms are widely thought to be much less sensitive than households to the rates they pay. Of course, they presumably pass at least some of their increased cost on to their customers.

If the reasoning behind the FCC's access decision is carried to its logical conclusion, the price of residential subscriber access will end up near its full cost, with the flat charges rising on average from less than $10 a month to more like $25 (in current dollars). It is this possibility that arouses fears that some households might simply have to do without phone service entirely, especially in high-cost areas.

If the reasoning behind the FCC's decision is carried to its logical conclusion, the price of residential subscriber access will . . . [rise] on average from less than $10 a month to more like $25. . . .

Maintaining Universal Service

Most agree that by now we have achieved universal telephone service. Today, more than 95 percent of the nation's households have at least one telephone, the figure varying from 72 percent in Alaska through 88 percent in Nevada to nearly 100 percent in Massachusetts and several other states. How much would residents of other states be willing to pay—how large would the network externalities be—if they could reach those last few thousand Nevadans and Alaskans? No one knows.

To most people universal service seems to mean 100 percent of all residences having telephones. But accessibility is not determined solely by whether there is a telephone in a home. Some people can be reached through a close neighbor's phone, or a pay phone down the hall, or a phone at work. Indeed, they may be more accessible on average than the person who has a phone at home but is seldom there. Finally, we cannot dismiss the U.S. Postal Service as a partial substitute.

Although the exact relationship between the number of subscribers and the degree of telephone accessibility is unclear, the two are surely related to each other. The next question is, therefore, to what extent would an increase in the price for access to the network lead some

(Continues on page 50)

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Toward Competition in Phone Service

A Legacy of Regulatory Failure

Nina W. Cornell, Michael D. Pelcovits, and Steven R. Brenner

STATE REGULATORS across the country are facing petitions from local telephone companies for dramatic increases in local residential rates—and in a companion piece here Leland Johnson says this creates a dilemma for regulators. Specifically, he argues that local residential telephone rates will double or triple—to about $25 or $30 a month on average—if local phone service is priced to cover the total cost of supply. The dilemma he sees for regulators is that raising local residential rates to the levels necessary to avoid the inefficiencies of pricing below cost will create political pressure for relief from high prices, relief that can only come by creating new inefficiencies.

We agree that the petitions for increases in local telephone rates signal a regulatory dilemma. We also agree that, if regulators refuse to price all forms of telephone service efficiently, the ultimate costs of service will be too high, and some of the benefits of advancing technology may be lost. We disagree, however, with Johnson's analysis of why local rates are rising and of what the consequences of failing to grant the requested relief will be.

Johnson blames past pricing distortions for the rate problems that regulators are facing today. In our view, however, despite serious problems with telephone company pricing, much of the pressure for higher residential rates is coming from a different source. The telephone companies are legally entitled to recover their total *book* costs, and those costs exceed total *economic* costs. As competition has spread to one service of the companies after another, local residential rate payers have become the last monopoly market from which the companies can recover these costs. Regulators now must decide how to deal with these high book costs as competition comes closer and closer to pro-

We disagree . . . with Johnson's analysis of why local rates are rising and of what the consequences of failing to grant the requested rate relief will be.

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viding substitute sources of supply for portions of local service, and thereby makes uneconomic book costs even more difficult to recover.

Costs and Efficient Prices

If local residential rates are not increased, Johnson says, there will be a shortfall in revenue that will have to be made up by charging long-distance and data services too much for their use of local access lines. Competitors of the local phone companies then will have incentives to supply build-around facilities that bypass the local companies' lines, even though the build-around facilities have higher economic costs than the local lines and thus are an inefficient use of resources. In other words, Johnson's call for higher local residential rates is based on the standard desire of economists for prices that reflect the actual costs of serving a consumer in order to send the correct signals to the market. He believes that the very large rate increases being requested would, if granted, "contribute to more efficient use of resources." Not surprisingly, the phone companies make the same claim.

Johnson supports his position with a widely held but never proven belief: that local residential rates are far below costs and have been subsidized by long-distance rates for at least the past twenty to twenty-five years. The evidence he presents on the costs of local service is based on data submitted by telephone companies in various rate cases. His reliance on this evidence implies that he accepts as valid two propositions: first, that the telephone companies' data represent the total economic costs of efficiently supplying these services today, and, second, that economically based methods have been used to allocate those costs to particular services, such as local, long-distance, and private line services. (For a brief description of the costing and pricing of telephone service, before and after January 1, 1984, see page 34.)

Neither of these propositions is correct. The cost data used by Johnson and others who agree with him are not the economic costs of supplying these services. They are, rather, the historical book costs actually incurred, allocated among service offerings according to a variety of often arbitrary and sometimes contradictory methods. Consequently, while residential rates of $25 or $30 a month might be necessary to cover stated costs, it is highly unlikely they would represent efficient prices in the sense usually meant by economists—the telephone companies' filings notwithstanding.

The basic reason that large local rate hikes ... are being proposed around the country is that telephone companies are entitled, under past court decisions, to an opportunity to recover all their historical book costs....

These historic costs, even if not efficient, are driving local rates higher. The basic reason that large local rate hikes (particularly residential) are being proposed around the country is that telephone companies are *entitled,* under past court decisions, to an opportunity to recover all their historical book costs, plus the allowed rate of return on those investments, regardless of whether those book costs match economic costs. Competitive markets would long ago have forced the telephone companies to adjust their costs to reflect economic costs, even if that meant having to take capital losses on some of their past investments. But regulators have no choice as the law now stands but to let the companies try to recover these uneconomic costs from the last remaining captive monopoly customers—residential users. If the high levels of local residential rates are disturbing, legislators should look at this aspect of regulation, not attempt to recreate past "subsidies."

The Existing Cost Data

Like all monopoly firms subject to rate-of-return regulation, a telephone company begins its preparation for a rate request by calculating the net book value of all the past investments it is permitted to include in the rate base. The company is entitled to recover a revenue requirement composed of the allowed rate of return on its rate base, plus depreciation, justifiable expenses, and taxes.

Most of a phone company's investment is in common plant—switches, wire lines to cus-

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tomers, and so forth—used to supply both monopoly and competitive services. The costs calculated for any one service depend on how these common costs are allocated. To examine the costs of providing the monopoly services, therefore, we must dissect the entire revenue requirement—looking at the rate base and the way it has been depreciated over time, as well as the justifiable expenses.

Such an examination is unlikely to find that the firm has invested over time in the most efficient technology for offering basic telephone service. As economists have shown in a long series of scholarly papers, beginning with a paper coauthored by Johnson ("Behavior of the Firm under Regulatory Constraint"), monopolies subject to rate-of-return regulation are unlikely to choose the most efficient technology or to operate it in the most efficient way. Rate-of-return regulation (coupled with legal barriers to entry by competing firms) cannot substitute for market discipline. On the contrary, it tends to give firms under its sway an incentive to invest far more capital than necessary as a means of increasing profits. Overinvestment appears in various guises: substitution of capital-intensive for more efficient labor-intensive production techniques, "gold-plating" of equipment, or overbuilding to meet peak demand stimulated by the distorted pricing structure of the regulated firm.

As economists have shown in a long series of scholarly papers, . . . monopolies subject to rate-of-return regulation are unlikely to choose the most efficient technology or to operate it in the most efficient way.

Perhaps the greatest benefit a regulated firm receives from overinvesting in common plant is increased ability to cross-subsidize competitive services. The firm has an incentive to choose a technology that uses common equipment for both monopoly and competitive services—*even when that technology requires a larger investment and is not the most efficient from the standpoint of consumers.* By using common equipment the firm increases its flexibility to assign a small part of these common costs to the competitive service and, therefore, increases its flexibility to set a low price. It is virtually impossible for regulators to detect, let alone prevent, this sort of "embedded" cross-subsidy.

Not only have the phone companies made investment decisions without regard for lower-cost alternatives, but their accounting practices have overvalued their assets. For one thing, until quite recently their depreciation schedules have failed to take account of technological changes affecting the industry. Over the past ten years, as telephone companies have been installing progressively newer generations of electronic switching and terminal equipment, advances in semiconductors have been rapidly reducing the cost of that equipment. But the companies have not adjusted their depreciation schedules to take account of the reduction in the value of mechanical equipment and earlier vintages of electronic equipment that are still in use. As a result they have large amounts of equipment that is overvalued on the books.

But the companies have not adjusted their depreciation schedules to take account of the reduction in the value of [earlier generations of] equipment that are still in use. As a result they have large amounts of equipment that is overvalued on the books.

The companies have also artificially increased their rate base by treating as a capital asset the labor costs of wiring new homes for telephone services and of connecting customers who move into homes already wired. Those costs have not been paid directly by the customer, but instead have accumulated in a capital account that is now over $15 billion. The economic value of the assets in this account is at best a small fraction of that figure.

Granted, there have been some changes. Recently, the industry applied for and received an acceleration of depreciation schedules for regulatory accounting purposes, and it began to expense the labor cost of wiring and connecting homes. But the new depreciation schedules may still be too long, and the sunk capital costs of equipment and wiring from years back remain on the books. Any firm not subject to

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rate-of-return regulation would have written these costs off as capital losses to its stockholders long ago—as Texas Instruments did recently in the case of its investment in the small computer market—and then reduced prices to bring them into line with existing costs of production.

In summary, during the fifty-odd years in which the telephone companies have been regulated monopolies, two to three generations of telephone technology have been invented, installed, and put on the phone companies' books, with managers all the while subject to incentives that lead away from least-cost technology and operations. Thus, it is highly likely that the companies have accumulated total (historical) book costs far greater than the total economic costs needed to provide adequate telephone service.

Cost Allocations

The difficulty with using total revenue requirement data to make judgments about efficient prices for a specific phone company service is further complicated by the lack of uniformity in the companies' methods for allocating total book costs among its various services. For competitive services offered within a state, a company normally tries to calculate what additional costs it incurs by offering the service, assuming that its competitive services are purely supplemental to its monopoly offerings. It then costs the monopoly offerings, using some method for fully distributing the remainder of the revenue requirement among them. Such computations require a number of assumptions about the proper way to assign costs to various services. In a given rate case a phone company will submit a number of different cost studies to support rates, often making different, and sometimes contradictory, assumptions about how to assign or allocate costs for specific parts of the service.

A case in point is the way most phone companies allocate the costs of the wires that run between the telephone central office and the customer. These wires, now being called access lines, make up a major part of the book cost of local phone service, particularly local residential service. Yet telephone companies are submitting different cost computations for identical wires depending on whether the wires are used for Centrex service or for business lines.

How it does this provides a good example of phone company incentives and tactics. Centrex is a service that competes with private branch exchange (PBX) equipment sold by both telephone companies and independent suppliers. With Centrex service, each of a customer's phones is connected to the central office switch by its own wire, just as if it were an independent line, and central office switching directs outside calls to the proper phone, handles intercom calls between phones, and provides special services such as speed dialing. With PBX equipment, many fewer lines to the central office are needed to handle the same number of telephones and outside calls, because it is the PBX that switches outside calls to the phones, handles intercom calls, and provides special services. Thus, if a PBX is used, there is a saving in the amount that is spent on wires.

Yet this saving is not apparent in telephone company cost studies because the companies

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do not assign the same cost to a wire used for Centrex as they do to an identical wire used for business service and attached to a PBX. The per line cost used for business or residential lines is assigned only to the number of Centrex lines that equals the number of lines the company says Centrex customers would have used if they had bought a PBX. The remaining, identical Centrex lines are assigned a much lower cost. Because the cost of Centrex wires is understated, cost studies seem to show that Centrex service returns more net revenue to the phone company than PBX service for similar size customers, even though the charge for PBX lines is higher and the investment in phone company facilities much lower.

Another reason not to rely on the costs the companies show for particular services is that their methods for allocating the costs of equipment used by more than one service are frequently flawed. When several services share equipment, some services may not need all of its capabilities. Local exchange switches, for example, have many capabilities that are needed not for local service but only to handle long-distance or international calls or to provide enhanced services in competition with equipment used by customers. The costs of the switch, however, are allocated to local, long-distance, or enhanced services based on limited characteristics such as relative use. It is not at all clear that such cost allocation methods accurately assign cost responsibility among the many telephone company services that use central office capacity.

Have Local Phone Rates Been Subsidized?

We began by noting Leland Johnson's argument that residential rates have to rise because competition from new technologies makes it impossible to continue the subsidy from long-distance service that has existed for many years. But has the subsidy in fact existed? Those who think so rely indirectly on the basic cost data and the methods of allocating those costs discussed above. For the interstate portion of the alleged subsidy, they often point directly to the cost "separations" process and the revenue flows to the local operating companies that result. Yet, while many people believe there has been a subsidy from long-distance to local service, there has never been a comprehensive study establishing either its existence or its amount. Furthermore, even if the alleged revenue flow from the interstate to the intrastate jurisdictions is reduced in the future, and similar flows from intrastate long-distance calling are also reduced, that will not demonstrate that the prices of local services have been set below economic cost.

. . . while many people believe there has been a subsidy from long-distance to local service, there has never been a comprehensive study establishing either its existence or its amount.

To determine whether long-distance service has provided a subsidy, two basic issues would have to be investigated. First, the economic costs that the local companies had to incur to supply long-distance service would have to be carefully calculated. Second, for the interstate portion, *all* revenue flows between the local companies and AT&T would have to be properly evaluated. In addition to the monies that flowed through the separations process, the operating companies also bought equipment and services from AT&T at prices that were not always equal to economic costs. The relevant sums to examine are thus the net flows from AT&T to the operating companies, rather than only the flows that resulted directly from the separations process.

Even if it were clear that the net revenue flow from the interstate to the intrastate jurisdictions were greater than the economic costs the local operating companies incurred in supplying interstate service, it still would not follow that local rates were below the economic costs of providing local service. To begin with, local exchange service has not been the only offering of the phone companies; they have also provided private lines and a number of so-called vertical services—Centrex intercommunications, call-forwarding, call-waiting, and a wide variety of business and residential telephone instruments. If the interstate jurisdiction paid more than the economic costs it imposed on the local companies, the excess may well have gone to cover some of the losses

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on those other offerings. Moreover, and probably much more important, the argument assumes that historical book costs equaled economic costs. But that assumption is wrong. Therefore, even if the net revenue flow to the local operating companies exceeded the economic costs that long-distance services imposed, the excess may simply have covered some of the uneconomic portion of total costs. It is possible, in other words, that local rates may already be high enough to cover the current economic costs of supplying local service, but not high enough to cover all the historical uneconomic costs.

"Subsidies," Local Rates, and Efficiency

The issue of historical subsidy flows will probably never be resolved. The coming divestiture, along with the change from the separations process to access charges, will alter the way the books are kept on telephone costs as well as how customers pay for services. What is important about the issue, however, is that, because so many people think a subsidy has existed, policies are being considered that would either attempt to replace it or would block further technological change in a vain effort to preserve it. Indeed, legislators, regulators, and phone company managements seem to have entered a topsy-turvy world where they expect the companies' competitive services—such as supply of telephone equipment—to subsidize the monopoly local exchange services.

... legislators, regulators, and phone company managements seem to have entered a topsy-turvy world where they expect the companies' competitive services—such as supply of telephone equipment—to subsidize the monopoly local exchange services.

If past "subsidies" remain the focus of attention, the real forces driving up local residential rates—uneconomic book costs—will be ignored, to the detriment of all. The rates currently being requested are designed to cover as much of their historical book costs as the companies think they can get away with imposing on local residential subscribers. And the legal history of rate-of-return regulation may well force the regulators to allow the companies to try to recover the whole amount, no matter how much in excess of economic cost it may be.

If this regulatory failure goes unexamined and uncorrected, politically unpopular levels of local residential telephone rates will not be the only unpleasant result. Worse still may be the policy makers' reactions to those rates. Legislators and regulators are already talking about trying to protect the monopoly revenue base of the existing phone companies by impeding new technologies that perform the same functions as local telephone services. And some are proposing to reduce local rates by undoing the FCC's recent access charge decision or by adding a permanent subsidy charge to the amount some or all long-distance carriers have to pay even if they do not use local exchange facilities.

Moreover, if telephone companies are free to engage in competitive activities while barriers are erected to preserve their monopoly bases, it is likely that the barriers will end up preserving the costing practices the companies use to justify rates. And if the existing practices are left intact, residential subscribers may end up covering more and more of the costs of the companies' competitive ventures. Those practices, even when faithful in theory to the economist's notion of efficiency, in practice are often manipulated so as to justify uneconomic provision of competitive services. There is simply no way to keep a regulated telephone company that faces little or no threat of entry from choosing technologies that in retrospect demonstrate that competitive services are covering marginal costs (and providing "a contribution" to the costs of monopoly services), but in reality actually lead to far higher costs and rates for monopoly services.

In summary, if the policy debate continues to focus on the wrong issues, three outcomes are predictable. Legal barriers to entry will be imposed to try to protect telephone companies from competition, and the companies will be required to price their services inefficiently. Technology and ingenuity will find ways around those barriers (albeit at some cost in efficiency). And the local residential rate payer will suffer the longest and the most from this failure to deal with regulatory failure. ■

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Toward Competition in Phone Service

The Case for Freeing AT&T

Michael L. Katz and Robert D. Willig

WHEN AT&T and the Department of Justice settled what had been the largest antitrust case in history, they agreed to sweeping changes in the long-distance telephone market that are designed to foster competition. The most dramatic of these is about to take place. On January 1, AT&T will spin off its twenty-two local operating companies, while retaining its long-distance arm (to be called AT&T Communications) and its unregulated communications and other businesses. This move is intended to ensure that the newly divested companies will not be tempted to favor AT&T over its competitors, such as MCI and Sprint, when granting long-distance carriers interconnection with local facilities. Other less visible changes in the way long-distance and local calls are hooked up also will make it easier for non-AT&T carriers to compete.

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While the settlement fundamentally restructures the long-distance market, it leaves intact the traditional regulatory framework—service-by-service rate-of-return regulation for AT&T Communications and simple rate-and-tariff oversight for its competitors. The question we raise here is whether pervasive regulation of AT&T will still be needed, once all of the provisions of the settlement are in place, or whether the discipline of competition can replace regulation in the long-distance market.

Chairman Mark Fowler of the Federal Communications Commission (FCC) seems to think competition can work. In a January speech he proclaimed that the FCC had already taken "the first steps to deregulate," and said he expected it to "step away" when the antitrust settlement and its own access charge ruling are in force. Others disagree. Stressing AT&T's 95 percent share of the long-distance market, they argue that continued public-utility-style regulation will be required for the foreseeable future. (For a brief description of the costing and pricing of phone service, before and after January 1, 1984, see page 34.)

Whatever the decision turns out to be, it should be based on a weighing of the social

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costs and benefits of continuing regulation. In our view, both the basic structure of the long-distance market and current trends in that market indicate that, once the settlement is in effect, competition (supplemented by limited regulatory oversight) will achieve the goals of pervasive, public-utility-style regulation at a lower cost.

The Costs and Benefits of Regulation

The social costs of regulating AT&T's long-distance operations are very high. Currently, each AT&T rate change is subject to FCC approval on the basis of mechanistic criteria which, by their nature, are not flexible enough to reflect changing market conditions. These rules deter AT&T from aggressive pricing, marketing, and investment strategies that would benefit its customers. They also put it at a disadvantage that may cause it to lose business to less efficient but unencumbered competitors. This cost is particularly large in times like the present, when the market is becoming increasingly competitive and technological change is so rapid and sweeping that the nature of services and their supply in five years' time is anyone's guess. If regulation is continued, innovation will be dampened, and costs and prices will be higher industry-wide than they otherwise would need to be.

There is another problem. Under current rate-of-return regulation, the price of a regulated service is tied (in theory, at least) to its costs, which makes it necessary for the FCC to determine how fixed and common costs are allocated among AT&T's various services. Through its Computer II decision (1980), the FCC has reduced the problem of allocating those essentially unallocable costs by requiring that AT&T group its competitive, unregulated businesses (customer premises equipment and enhanced telecommunications services) in a subsidiary that deals with the rest of the firm at arm's length. This may be the best way to deal with the problem, but it is socially costly because it prevents the efficient sharing of facilities and administration company-wide. In the absence of regulation, there would be no need for this inefficient separation.

Finally, continued regulation will divert corporate energies away from forms of competition that benefit telephone consumers. Much of the competitive interaction between AT&T Communications and its less regulated rivals will be played out in lengthy proceedings before agencies and courts, not in bringing new and better services to the market.

Even substantial social costs might be justified if regulation were the only way to attain some crucial policy goal. In this case, the goal is to ensure that AT&T does not exercise market power—that it does not raise prices to inefficiently high levels. Thus, the fundamental question in calculating the benefits is this: would AT&T, in the absence of regulation, find it profitable to raise its long-distance prices substantially, on average, for a sustained period? If the answer is yes, continued regulation will be needed to protect society from AT&T's exercise of market power. If the answer is no, competition will be able to enforce essentially the same pricing discipline that regulation aims at, and the benefits of continued regulation will be small relative to the high costs.

Whether AT&T would find it profitable to increase its rates would depend on the degree to which its customers responded to rate hikes by buying less of its services. They could do this either by curtailing the overall quantity of long-distance phone services they consumed or by switching to alternative suppliers. The statistical studies of the demand for long-distance services that Lester Taylor has surveyed suggest that the first of these—curtailing consumption—would not be sufficient to deter price rises (*Telecommunications Demand: A Summary and Critique,* 1980). So the issue comes down to whether sufficient numbers of consumers would switch to alternative suppliers if AT&T raised its prices.

Whether AT&T would find it profitable to increase its rates would depend on the degree to which its customers responded to rate hikes . . . by curtailing the overall quantity of long-distance phone services they consumed or by switching to alternative suppliers.

For a significant block of AT&T's customers to switch, it would not be enough for them

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SORRY, BUT WITH DIVESTITURE AND ALL, THAT IS NO LONGER OUR RESPONSIBILITY — TRY AUTOMATED DING DONG
STRIKE FOR WAGES & JOB SECURITY
AT&T
STRIKE FOR WAGES AND JOB SECURITY
SORRY, THAT'S NO LONGER OUR AREA — PERHAPS YOU COULD TRY SOUTHERN AUTOMATED BELLOFONE
SORRY, WE CAN'T HELP YOU — YOU MIGHT TRY NORTH EASTERN AUTOMATED PHONE, INC.
WE DON'T HANDLE THAT — TRY THE DRY CREEK AUTOPHONE AND CATTLE COMPANY
SORRY, NOT OUR DEPARTMENT — TRY SOUTHWEST COMPUTOPHONE AND STORM DOOR
DAM' PHONE NEVER STOPS! WHAT IS IT NOW??
WATSON, COME HERE — I WANT YOU
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simply to respond to the change in relative prices by deciding one day that they wanted to sign up with competing carriers. The competing carriers would also have to be willing to expand their capacity to take on the new customers. We argue here that both these conditions are likely to be met once the antitrust settlement has restructured the long-distance market.

Restructuring the Long-Distance Market

The Modified Final Judgment that codifies the settlement implements the split between local and long-distance services by defining approximately 160 regions known as local access and transport areas (LATAs). All telephone services between points within a single area, or LATA, are considered to be local, and all services between areas are considered to be long-distance.

Typically, the connection between the subscriber's phone and a long-distance carrier will be made through a local company's facilities, but it will also be possible to route long-distance calls over facilities that bypass the local companies. The judgment requires every local company to reconfigure its equipment by 1987 so that, for each area it serves, the company can provide any long-distance carrier with interconnection to all telephones through a single "interface" between its facilities and those of the carrier. (For this interconnection, the carriers will pay the local company through a system of charges.) The object is to guarantee all carriers the availability of access of equal quality to the local networks. To discourage the local companies from being discriminatory in granting access, the judgment expressly forbids them from offering long-distance services themselves. Up to now, the access provided to AT&T's competitors has been inferior to that enjoyed by AT&T, so that they have had to either spend money upgrading their service or settle for offering their customers lower quality.

A second equal access provision requires that consumers be able to use all long-distance carriers with equal ease. A consumer will be able to designate any one firm as the automatic carrier of his or her long-distance calls and also, by dialing a short code number, will be able to reach any nondesignated carrier. The dialing codes will be of equal complexity for all such carriers. In contrast, the consumer who wishes to use one of AT&T's competitors today

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must have a push-button phone (or purchase a special adaptor) and must dial approximately twelve extra digits. Thus, competing carriers have trouble selling their services to the roughly 60 percent of households that have rotary phones.

Will Consumers Switch?

Consumers in increasing numbers are already demonstrating their willingness to use an AT&T competitor when it offers lower prices. MCI now has almost 1.3 million long-distance subscribers, compared with 350,000 two years ago, while Sprint, GTE's long-distance division, has 651,000. By the late 1980s consumers should be even more willing to switch, for several reasons. First, assuming that the local phone companies meet their equal access obligations on schedule, the services of the competing carriers will be higher in quality and easier to use. Second, consumers will become less reluctant to switch suppliers as they grow to know and trust competing firms more. By the end of the decade, firms such as MCI and Sprint will have been in business for many years, and companies that have well-established reputations in other lines of business may have entered the market.

Moreover, the market will become increasingly sophisticated. There will be more "resellers"—firms like U.S. Telephone Inc., Satelco, and Combined Network Inc. (which offers its service under the name of Allnet) that buy bulk services from a carrier or carriers and then resell them in smaller packages to consumers. A reseller may serve two roles. By pooling its customers' demands, a reseller can obtain quantity discounts that are passed on to its customers, each of whom may have a small individual demand. Also, a reseller can shop around to find the best carriers for its customers' calls. Already there are automated services capable of matching consumers and carriers on a call-by-call basis. In the future, consumers will come to rely on resellers much as they rely on independent insurance agents. And some well-known retail and service firms may enter the business. Resellers, along with large corporations that are heavy long-distance users (several companies have annual telecommunications budgets that exceed $100 million each), will have the incentive and the ability to analyze the services and prices offered by each carrier to determine which are best.

In short, consumers should become increasingly responsive to price differentials between carriers. This will be particularly true of heavy users, who generate a large proportion of total traffic. In 1976, for example, the 4 percent of households having the largest individual demands generated 30 percent of all household interstate calling. Business demand is even more strongly concentrated. Thus, only a small fraction of all consumers need switch in response to an AT&T price increase to make it unprofitable.

Will Competing Carriers Expand?

AT&T Communications faces a growing variety of rapidly expanding competitors. MCI is spending $1 billion for expansion in the current fiscal year, and GTE says it will spend $8 to $10 billion over the next decade on Sprint. New firms are entering as well. For example, Citicorp has created its own telecommunications subsidiary, Rochester Telephone recently announced plans to build a long-distance optical fiber network in New York state, Starnet now uses satellites to handle long-distance calls originating from hotels, and SBS uses satellites to offer both long-distance telephone and sophisticated data services. Finally, some resellers are beginning to invest in their own transmission facilities.

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Expansion Incentives. Would these and other carriers be able to expand fast enough to serve the wave of consumers that might desert AT&T if it increased prices? Clearly, one condition that must be met before an existing carrier will expand its services, or a new carrier will enter the market, is that the expected prices exceed

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the unit costs of expansion. The fact that firms are now committing hundreds of millions of dollars to expansion indicates that this condition is already satisfied.

But the point must be put in perspective. Existing regulations may distort the investment incentives of the competing carriers in two ways. First, AT&T's long-distance arm currently pays a higher charge for interconnection with local telephone networks than does its competition. Some (including AT&T) claim that this discrepancy favors the competing carriers, while others say that it is more than justified by the fact that the competing carriers get inferior access. If the former is true, then investment by competing carriers has been artificially stimulated and may fall in the future. Second, under the FCC's jurisdiction, AT&T charges the same price for any two calls of equal distance, even though the costs may differ greatly. That might mean that competing firms, which are not required to engage in "rate averaging" or to serve all customers across the country, could be undercutting AT&T's prices on lower-cost routes (without necessarily having lower costs than AT&T). If so, then their investment might tail off if mandatory rate averaging were removed. As equal access is implemented, we must watch what happens to the continuing level of investment by competing carriers, particularly if AT&T is allowed to "de-average" its rates and thus compete on more equal terms.

A second condition for expansion is that the investment not be thought overly risky. Of the kinds of transmission facilities a long-distance carrier might choose—land-based microwave, optical fiber, or satellite microwave—the last should carry particularly low risk. There is a well-developed lease market for satellite facilities, and satellite capacity is expected to quadruple between 1982 and 1987. Much of the necessary ground equipment can be moved to new locations relatively cheaply. Thus, if an expansion proved to be unprofitable, the carrier could retrench without substantial losses simply by terminating its leases and moving or selling its ground equipment.

Land-based microwave and optical fiber transmission facilities are much more costly to relocate. A given set of facilities, however, may be used as a component of complex network links to connect many different LATAs and to provide many different services. This fact has two important consequences. First, by diverting capacity that was serving other routes or services, a competing carrier could expand its supply in the area where prices had risen without constructing any new facilities. Second, if the firm did construct facilities in that area and the expansion proved unprofitable, the facilities could be used to serve other long-distance telephone routes (in some cases combining the facilities of several carriers) or to provide other types of telecommunications services, such as data transmission. For a reasonably rich network, the risks of local expansion even for a carrier using land-based microwave or optical fiber are likely to be very low. Of course, when the expansion is a response to a nationwide price increase, the geographic fungibility of capacity is a less effective means of reducing the risk, although it remains possible for a competitive carrier to reallocate capacity to different services.

There are two additional factors that reduce the risk of expansion. First, if AT&T raised its prices to levels that covered the expansion costs of competing carriers, these carriers could profitably sign long-term contracts with brokers and big businesses, undercutting AT&T's prices, and large consumers of telecommunications services might find it profitable to construct their own facilities. In either case, the expanding firm would be guaranteed enough traffic to cover the costs of expansion, at very little risk. The second factor reducing the expansion risk is that telecommunications demand has grown by almost 10 percent a year over the last decade, and there is no reason to expect it to stop. Thus, if a firm expanded in response to an AT&T price increase and AT&T then reversed itself and cut prices, the expanding firm could in due course find the additional business it needed.

Anticompetitive Practices. Given the market conditions that should prevail by the end of the 1980s, we would expect competing carriers to expand in response to any substantial and sustained AT&T price increase. But what about price cuts? Without rate-of-return regulation, would AT&T engage in anticompetitive or predatory price wars to scare off competition? Indeed, if we suppose that AT&T could plausibly threaten to cut its prices enough to make a com-

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petitor's new investment unprofitable, then the competitor might be unwilling to make irreversible investments in new capacity, and the growth of competitive firms would cease. The question, however, is not whether AT&T could pursue such a strategy (which might, incidentally, violate antitrust law) but whether AT&T would find it profitable. For the strategy to work, AT&T would have to convince all and sundry that it would respond to each new competitor by lowering prices sufficiently to make the competitor suffer losses. A firm coming into the market with a low irreversible investment (for example, using satellite transmission and renting satellite capacity) could call AT&T's bluff at little cost. If AT&T did carry out the threatened price reduction, and stuck to it, the entrant could exit cheaply and still be waiting in the wings, while AT&T suffered huge revenue losses. The upshot is that nobody would be effectively deterred by such a threat.

If AT&T did carry out the threatened [predatory] price reduction, and stuck to it, the entrant could exit cheaply and still be waiting in the wings, while AT&T suffered huge revenue losses.

And if the expanding firm did commit itself to substantial irreversible investments in new capacity, AT&T price cuts could not drive this capacity from the market. In order to make the competing carrier scrap the new facilities, AT&T would have to threaten plausibly to hold prices below variable costs for the life of the competitor's facilities. A below-cost pricing strategy would hurt AT&T much more than the expanding firm, because AT&T has a much larger market share and because it would have to hold down prices throughout the many regions and types of services that the entrant's facilities could serve through network interlinking. Moreover, large consumers would still have an incentive, if only for safety's sake, either to build their own facilities or to sign long-term contracts with non-AT&T carriers whenever AT&T tried to raise its prices above incremental costs. Either way, the retaliatory price reductions would do AT&T no good.

Another way AT&T might try to block competition would be to make preemptive purchases of particular resources that a carrier would need. For example, if AT&T could buy or lease all the transponder capacity suitable for voice transmission, it could deter satellite expansion by carriers. But for preemptive purchasing to be a threat, the supply of the required input must be limited, and that condition applies to only a few areas—satellite capacity, spectrum space, and rights-of-way for land-based transmission links. In these areas, the FCC could adopt a simple set of rules that would prevent predation, while interfering very little with normal market activity. For example, the commission might forbid AT&T from signing contracts for exclusive use of optical fiber rights-of-way. Pervasive rate-of-return regulation is not needed to prevent the monopolization of inputs; in fact, the existing body of antitrust law might well turn out to be sufficient.

Policy Conclusions

Our analysis indicates that competition in the long-distance telephone market can work. Today, large numbers of consumers are beginning to use competing carriers and resellers, existing carriers are expanding, new firms are entering the market, and the market is continuing to grow. Moreover, the conditions affecting entry and expansion in the industry are such that competition should strengthen as the divestiture and equal access provisions of the antitrust settlement are implemented.

In short, there is good cause for beginning the transition to deregulation without delay. Even so, policy makers should manage that transition carefully, watching for continuing signs that competitive entry and expansion are indeed working to limit AT&T's ability to raise prices. For example, one useful indicator of the ability of competing firms to expand in response to an AT&T price increase is whether there is still enough satellite capacity available for diversion to interLATA traffic without causing a substantial rise in the price of satellite time. Similarly, continued growth of the market would indicate that the risks of overbuilding in response to a price increase are low. Comparing the market shares of AT&T and its competitors also conveys information—but, contrary

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to what some have claimed, it is not by itself a sufficient test. The market shares of the non-AT&T carriers are relevant only to the extent that they demonstrate the carriers' ability to expand their output significantly in response to an AT&T price increase, and a group of firms may have this potential even if their combined market share is small.

During the transition period, special rules might be needed to keep AT&T from exploiting temporary market power. The competing carriers, for example, may need a few more years before they are able to expand sufficiently to make a large price increase (say, 50 percent) unprofitable for AT&T. It thus might be useful to put a temporary cap on the size of permissible increases. Even after the transition period, of course, we would not have to rely solely on market forces. Existing antitrust laws should be enforced, and some other residual regulations might be needed as well. There may be a few local areas so small and isolated that a second carrier cannot achieve large enough economies of scale to compete with AT&T. Some minimal form of continued regulation might be appropriate in those areas—perhaps price ceilings defined in relationship to market prices in areas where there is effective competition.

. . . a decision to deregulate need not be irreversible. . . . But if we refuse to start the process—if we do not give competition a chance—we may miss the permanent benefits of increased innovation, efficient supply, and lower prices that it could bring.

Finally, it is well to remember that a decision to deregulate need not be irreversible. If the market signs change in the course of the transition and indicate that competition is not working, we could pull back from deregulation —suffering, at most, temporary social losses. But if we refuse to start the process—if we do not give competition a chance—we may miss the permanent benefits of increased innovation, efficient supply, and lower prices that it could bring. ■

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Why Local Rates Are Rising
(*Continued from page 36*)

subscribers to drop out? The evidence suggests that even substantial price increases would have a rather small effect. To begin with, econometric studies of the demand for network access have shown that doubling the price would reduce the number of subscribers by about 10 percent (Lester Taylor, *Telecommunications Demand: A Survey and Critique*, 1980). Second, the forthcoming rise in local rates will be accompanied by lower long-distance rates, probably intrastate as well as interstate. These lower rates will provide a double incentive for subscribers to stay in the system: both because they could expect to get more incoming calls and because they would place more long-distance calls themselves. Overall, then, the reduction in subscribers should be even lower than the previous studies would suggest.

To be sure, the states with especially high subscriber access costs will be hit harder than the average. But it turns out that these same states will get a disproportionate advantage from the lowering of long-distance rates. In 1981, for example, the residents of Nevada and Wyoming spent about 19 percent and 17 percent (respectively) of their phone time on interstate calls, compared with a nationwide Bell System average of 8 percent. Thus, the residents of Nevada and Wyoming should be more willing to continue telephone service than residents elsewhere since they will enjoy large benefits from lower interstate rates.

Of course, none of this provides much comfort to state regulators, state legislators, and members of Congress. They will have to listen to complaints about higher phone bills, even if not a single household drops out of the system. Those complaints will be especially persistent because, in contrast to the situation with electricity prices, the increases in phone rates will reflect not obvious increases in underlying costs, but only a change in how costs are covered.

Can Regulators Maintain Low Rates?

For better or worse, members of Congress, state regulators, and others are casting about for ways to relieve the pain of rising local rates. It is instructive to consider alternatives that might do that while holding efficiency losses to a minimum.

Taxing All Long-Distance Carriers. There is, of course, the possibility of trying to preserve the current system with as few changes as possible. The obvious way to do this would be simply to enlarge the universal service fund in future years as particular states find it harder to subsidize residential access. But imposing substantial charges only on those long-distance carriers that connect their subscribers through local telephone lines would simply exacerbate the bypass problem that the FCC seeks to mitigate.

[The approach] embodied in the Packwood and Dingell-Wirth bills . . . would avoid the bypass threat. But it would discourage long-distance calling. . . . [while] penalizing the development of new and lower-cost technologies. . . .

So attention in Congress is turning in a different direction. Local rates could be kept down nationwide, or just in high-cost areas, by levying a charge on *all* long-distance carriers, whether or not they require access to the local telephone systems. This approach, which is embodied in the Packwood and the Dingell-Wirth bills, would avoid the bypass threat. But it would discourage long-distance calling to a greater degree than other alternatives. Moreover, such a clear-cut case of penalizing the development of new and lower-cost technologies raises major issues of national economic policy.

Low-Cost Loans. Another idea borrows from an old New Deal program. Today 95 percent of rural homes have telephones, compared with only 38 percent in 1950, thanks in large part to federal loans and loan guarantees made to rural telephone companies at low interest rates. Similar loans and loan guarantees could be used now to help reduce access rates in rural areas. However, any policy of subsidizing rural access per se is open to charges of inequity, one reason being that many rural people do not have particularly low incomes, especially in the West. Why—it would be asked—should working-class city dwellers pay taxes to bring telephones to

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cattle ranches and oil fields? "Network externalities" are a poor justification, since middle-class ruralites will buy telephones whether they are subsidized or not.

Thus the question arises: why not subsidize just the poor?

Telephone Stamps. One straightforward way to reach the poor would be to establish "telephone stamps" as an add-on to the food stamp program. The recipient would cash in the stamps to cover some specified maximum dollar purchase of local telephone service. This approach would target many of those most likely to drop phone service as rates rise. It would also have the advantages of drawing on the food stamp administrative machinery already in place and putting the burden of subsidy on the general taxpayer, rather than on users of other telephone services priced above cost. Finally, the total outlay it would require (for any given level of subsidy) would be much lower than the one that would be needed to subsidize access across-the-board, since only about 8 percent of households are food stamp recipients.

Despite these advantages, this approach would be hard to sell. Economists are fond of saying that subsidies should be made explicit in order to subject them to public scrutiny. But politicians tend to prefer internal subsidy schemes whose costs do not appear as a line item in anyone's budget. Moreover, it is not clear why, if the food stamp program is to be expanded to include nonfood items, telephone service should be the top item on the list. A more compelling case might be made for fuel aid, or clothing, or shelter, or any other basic human need.

"Lifeline" Pricing of Access. "Lifeline" service, which is already used in some areas, employs a flat below-cost access fee, along with higher separate charges for local calls to meet the revenue shortfall. This approach has the attraction of not requiring explicit subsidies from taxpayers. On the other hand, it would be economically inefficient because some local calls would be priced above cost. And the higher the charges for local calls, the greater the incentive to bypass subscriber lines and compete with telephone companies for *local* service. Moreover, the task of metering local calls would be an additional burden to local exchanges that do not now have metering equipment. Finally, unless some kind of means test is incorporated in the scheme, the subsidies are untargeted.

Despite these problems, lifeline service may prove to be a workable compromise. If it is targeted only to the poor (food stamp recipients, for example), the burden imposed on local calls might be small enough that uneconomic bypass would not be a serious problem.

BECAUSE THE ALTERNATIVES for keeping residential access rates low have serious drawbacks, it is likely these rates will rise toward the actual cost of service. This should stimulate more use of long-distance services and more cost-cutting efforts in local service—both of which should contribute to more efficient use of resources. Carefully targeted subsidies through a universal service fund—a political compromise—*may* suffice to keep rates within reasonable bounds in the highest-cost areas. Lifeline service with a means test might also help.

Moving beyond the current controversies, we should remember that our dilemma has been brought on by our good fortune. The new technologies responsible for the transformation of the industry are, overall, cutting the cost of transmitting information dramatically and stimulating a badly needed increase in the nation's productivity. Like the robot welders on GM's assembly lines, the new telecommunications technologies will benefit society as a whole. But not everyone will be better off—and that is why the problems arise. ■

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U.S.-Canadian Railroads
(Continued from page 13)

make clear who has to file the combined rate on northbound traffic ("a joint tariff shall be filed"). Furthermore, Canadian railways find it impossible to file a "true" joint through rate with the Canadian Transport Commission. Not having been a party to the contract, they often have no idea what a shipper will actually end up paying; all they know is how much they themselves will get out of it. The U.S. carriers sometimes refuse, on grounds of confidentiality, to let the Canadian lines look at their contracts with shippers for movements that will take place in part on the Canadians' tracks. This refusal may even be legally obligatory: U.S. antitrust law may forbid one carrier to tell another about its confidential rebates to the extent that the two are competitors.

What makes these asymmetries so damaging to the Canadian railways is that they do compete with the Americans for business. For example, a railway frequently approaches a prospective shipper offering to take a lead role in coming up with an attractive transportation package, and then gets in touch with the connecting carriers it plans to use. Its aim is to steer shippers to its preferred routing, usually the routing that goes largely over its own track. U.S. carriers commonly offer a larger rebate on through-rate traffic to shippers that use more of their own track. The Canadians cannot match these rebates (and, as already explained, cannot negotiate at all with shippers who demand confidential contracts). When their U.S. counterparts arrive at a final contract, routed mostly over U.S. lines, they may agree to clauses, such as volume commitments or penalties for late delivery, that their Canadian partner would never have accepted (and may perhaps never even find out about).

Many Canadian shippers, meanwhile, having watched U.S. shippers take rebates from U.S. carriers with impunity, have started taking them too, although they risk incurring a $1,000 fine under Canadian law each time they do. Incidentally, Canadian railroads can offer what are in effect legal rebates by publishing volume discount rates tailored to particular shippers, but many shippers seem to prefer rebates to these volume discounts, even aside from reasons of confidentiality.

Canadian carriers are also losing out on what is called "overhead" traffic, traffic that moves from one U.S. point to another through Canadian territory. These routes usually compete directly with those of U.S.-based carriers. For its part the ICC, in judging the "reasonableness" of international through rates against charges of unfair competition, has on several occasions asserted jurisdiction over Canadian railways whose actual control of the goods being shipped was limited to Canadian territory.

A third area of inconsistency concerns rules on liability for lost, damaged, or delayed freight. Previously both countries maintained similar rules: a railroad could not agree with shippers to limit its liability, nor could it contract out of liability without the approval of the regulators. Now, while Canadian law continues to specify how much damage a railway is liable for and how soon shippers must file damage claims, a U.S. carrier is free to agree with a shipper in writing to limit liability.

For example, suppose a shipper wants to send goods from the United States to Canada at a through rate, interchanging them from a U.S. to a Canadian railway at the border. The shipper signs a contract with the U.S. carrier agreeing not to sue for any damages that come to less than $200 per unit, and agreeing to submit notice of damage within one month. Two months after receiving the goods, the shipper's Canadian office announces that the product has suffered damages amounting to $150 per unit. Canadian law requires a railroad to reimburse shippers for any damages that were not present when the goods were shipped and also gives a shipper four months to give notice of damage. So the shipper, who is barred from suing the U.S. carrier because of two contract clauses, sues the Canadian railway instead, even though it was no more likely to have caused the damage than its U.S. counterpart.

Inconsistencies of this sort are a powerful force pushing the two countries' regulatory systems closer together, in fields ranging from telecommunications to airlines (see Readings, p. 58). The ICC hardly seems tempted to reverse its deregulatory policies to accommodate the Canadians, but the Justice Department might take this opportunity to reconsider whether the Sherman Act is really an American product suitable for export.

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Readings
of particular interest

Early Retirement for Buses?

"Capital-Biased Subsidies, Bureaucratic Monitoring, and Bus Scrapping" by Mark W. Frankena (Federal Trade Commission, Bureau of Economics working paper no. 83), April 1983.

The U.S. government and several Canadian provincial governments offer subsidies to local transit agencies that buy buses and subway cars. These subsidies are larger than the subsidies that go toward the actual cost of operating the vehicles—which (economists have suggested) gives the programs something of a "capital bias" toward overinvestment in equipment by local transit agencies. Governments in both countries, recognizing this bias, have put "strings" on their grants to discourage such overinvestment. Mark Frankena, an economist at the University of Western Ontario, studied the subsidies given to city transit systems in Ontario; the empirical data he found supports the hypothesis that the programs encourage inefficient overinvestment and that the "strings" have been of little use in remedying the problem.

In the absence of subsidies, an aging bus will theoretically be scrapped at the economically optimal moment. That will be the point at which the combined costs of maintaining it and of forgoing the qualitative benefit of modernization begin to outweigh the cost of buying a replacement. Capital subsidies lower the latter expense to the city but not the two former expenses; thus, Frankena suggests, they will lead local officials to retire old buses and buy new ones sooner and more often than is economically justified.

Earlier models of bus replacement decisions have suggested that the inefficiency may be of a significant magnitude. A 1980 study by R. F. Armour analyzed the effect of an 80 percent federal capital subsidy on the age at which buses would be replaced in Seattle, Washington. Armour's model found that the optimal economic replacement age for buses under Seattle conditions ranged from 20.5 to 26 years, but predicted that under federal subsidies the transit agency would find it profitable to retire buses at between 8.5 and 10 years of age. Armour did not, however, test these conclusions empirically.

Governments have not been unaware of the potential for distortion inherent in these subsidy programs. Often, in fact, they have added command-and-control regulations to the programs in an attempt to ensure that no bus is scrapped before its time. Both U.S. and Canadian officials claim that they will withhold funds for new purchases if municipalities try to retire existing buses before they reach the end of their "expected" life, which is about fifteen years. Some officials insist that these controls have prevented any actual premature scrapping of buses. Although "there may be a *perceived* bias in favor of capital replacement as opposed to maintenance," the Ontario transport minister has claimed, "there's no indication the *perceived* bias has influenced replace-repair decisions."

Frankena points out that merely installing controls to deter bus scrapping will not necessarily solve the inefficiency problem. For one thing, the process of control itself involves administrative costs that would be unnecessary under a neutral subsidy program. Furthermore, the prevailing regulations allow authorities to scrap buses more than fifteen years old even though it is sometimes inefficient for them to do so. Finally, the author suggests, cities may find ways to evade the controls, either by scrapping an old bus at one time and buying a new bus at another, or by taking buses out of service but not formally scrapping them until they reach the age of fifteen.

To test this hypothesis, Frankena constructed an econometric model of the Ontario urban transit systems' decisions to scrap

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buses, using data from 1963 to 1981. After controlling for ten variables, he found that the capital bias of the subsidies caused Ontario buses to be retired earlier than they should have been. He also tried to determine whether or not the Ontario regulations have succeeded in lessening the chances that a bus will be scrapped prematurely. He concluded that the official claims of success were not borne out by the available evidence: "bureaucratic monitoring procedures did not prevent an increase in the scrapping probability even for buses under fifteen years old."

Frankena notes that his study did not find as great an inefficiency as the theoretical models had predicted, even allowing for the fact that the Ontario subsidies had less of a capital bias than the U.S. subsidies studied earlier. He believes, however, that both the new and the old studies show that capital-biased subsidies create significant unnecessary costs compared with more neutral subsidy schemes.

Truth-in-Simplification

"A Survey of the Mortgage Banking Industry Concerning Costs and Benefits of Regulations" by Louis Harris and Associates (John M. Boyle, project director), September 1982, 95 pp.

In 1968 Congress passed the Consumer Credit Protection Act, Title I of which is known familiarly as the "Truth-in-Lending" law. The law requires lenders to tell potential borrowers the total finance charge, total payments, and annual interest rate on their loans. The power to implement the statute was given to the Federal Reserve Board, which drew up a set of specific guidelines known as Regulation Z. This Louis Harris survey of mortgage lenders, commissioned by the Joint Economic Committee of Congress, suggests that small lenders spend disproportionately more to comply with the act, and that a congressional effort to streamline the law three years ago may have backfired.

During the 1970s the Truth-in-Lending law was frequently criticized as confusing and difficult to comply with. Enforcement agencies reported that less than 20 percent of banks were in full compliance. By 1980 the Fed had published more than 1,500 interpretations of Regulation Z, and litigants had filed more than 13,000 lawsuits involving the law's provisions. Congress responded to the complaints in that year by passing the Truth-in-Lending Simplification and Reform Act, and the Fed in turn formulated a revised version of Regulation Z based on the 1980 act. The revised disclosure rules became mandatory in October 1982.

At the JEC's request, the Federal Trade Commission (which enforces the law among non-deposit-taking lenders) asked Louis Harris and Associates to conduct a survey to determine how much both the old and the new Regulation Z have cost the mortgage banking industry. Mortgage bankers were the second largest source of residential mortgage money in 1980, accounting for some $33 billion in loans. (Among the other lenders covered by the Truth-in-Lending law are commercial banks, savings and loans, and credit unions.)

The surveyors queried 201 company members of the Mortgage Bankers Association of America. As in Harris's previous study of the impact of regulation on medical device makers (see Readings, *Regulation*, March/April 1983), regulatory costs apparently fell disproportionately on smaller firms. The largest firms said in 1980 they spent $0.23 to comply with Regulation Z for every thousand dollars in new loans they made. The smallest companies said they spent $0.67 per thousand, nearly three times as much. Projecting the sample to the whole industry, Harris estimated that the total costs of compliance amounted to $11.9 million in 1980 and $13.2 million in 1981. The bankers surveyed said that the biggest costs imposed by Regulation Z have consisted of training personnel (24 percent), explaining the annual percentage rate to consumers (22 percent), and obtaining legal advice or printing forms and pamphlets (14 percent each).

Slightly more than one-third of the firms said they began converting to the simplified regulations by mid-1982. These companies reported that their cost of compliance jumped by 45 percent in that year. Among the costs they encountered to implement the switch were printing (30 percent), computers and employee training (27 percent each), the hiring of new employees (24 percent), and new equipment (19 percent). The average firm said it took 270 labor-hours to convert to the revised regulation. Again extrapolating the fig-

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ures to the entire mortgage banking industry, Harris concludes that just the process of converting to the revised rules would cost $8.8 million—around three-quarters of the annual cost of the old regulations.

Although the mortgage lenders were among the intended beneficiaries of simplification, they are not favorably impressed with the results. Of those who had begun conversion, only 8 percent reported that the new law had reduced or eliminated any of their ongoing costs, and 39 percent reported that the revised regulations actually inflicted some new ongoing costs. Harris observes that the benefits of the revision may "become more evident as time goes on. However, at the present time the costs of conversion . . . seem more salient to the industry than the hoped-for cost savings."

Harris also asked the mortgage lenders what they would do in the absence of a Truth-in-Lending law. Among the items they said they would no longer routinely disclose were annual percentage rates (56 percent of respondents), the finance charge (42 percent), the total payments (44 percent), and the amount financed (47 percent). Some also said they think various aspects of the law are counterproductive for consumers, especially the annual percentage rate, which some mortgage bankers said could be "genuinely deceptive" when applied to increasingly popular forms of "creative financing."

On the Road to Private "Infrastructure"

Roads and the Private Sector, edited by Eamonn Butler, and *Private Road Ahead: Ways of Providing Better Roads Sooner* by Gabriel Roth and Eamonn Butler (London: Adam Smith Institute, 1982), 103 pp. and 32 pp.

Although road users pay for roads through gasoline and other taxes, governments decide how and when to build new roads based on what can amount to essentially political grounds. As a result "those who would like to 'buy' more or better roads . . . have no way to make their desires felt, except through a very inadequate political process," writes Eamonn Butler, director of the Adam Smith Institute, in his foreword to *Roads and the Private Sector*, an anthology of essays on privatizing roads. "Their preparedness to pay is never called upon, so it never attracts new investment where it is needed economically," Butler says. "Heavily congested roads are 'rationed' by overcrowding."

Butler and Roth, in a shorter work that summarizes the essays, argue that the British government has failed to spend as much on "infrastructure," especially inter-city roads, as would be economically justified. "Capital items have fallen from 22 percent of general government expenditure in 1970 to only 10-1/2 percent in 1980." Unwilling to curb growing transfer payments to individuals, London has repeatedly cut road expansion and maintenance funding instead, the authors argue. Although completing various road-building projects would save British shippers an estimated $2.2 billion a year, the government has shelved the projects for lack of money.

The costs of an inadequate road system, they maintain, go beyond added travel time for freight shippers and motorists. The failure to build beltways and bypasses to replace routes through cities makes traffic less safe and worsens such environmental problems as urban noise and the transport of hazardous materials; stop-and-go traffic is also bad for energy efficiency.

In 1982 various companies in the British road-building industry offered to form a private consortium to finance the building of inter-city roads. The consortium would get its investment back over a stated period, such as twenty years, in accord with a formula based in part on the traffic volume achieved on the new roads. At the end of the period, the consortium would hand the ownership and operation of the road over to the government.

The government's transport ministry reacted with cautious enthusiasm to the road-builders' proposal. It issued a discussion paper exploring the financial terms under which such a scheme might proceed, but asserted that it wanted to keep full rights to select the routes and design the highways. It also made clear that it would require the eventual reversion of the roads to government ownership and operation, as the consortium had suggested.

These two works, both published by the Adam Smith Institute in London, analyze some

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proposals for private sector involvement in roads. The most modest of the proposals examined would merely alter the way the government borrows long-term funds under its current road-building system. More ambitious schemes would assign more of the risk for the roads' eventual success (as measured by the volume of traffic) to the private companies that build the roads—conceivably all the way up to allowing the companies to own the roads outright and charge tolls or other fees to pay for them. Private toll roads were once common, and some are still being built, among them the privately financed French motorway L'Autoroute de L'Est.

The more ambitious plans for private involvement in road operation raise some added questions: Could private owners design roads to their own standards? Could they lawfully exclude certain classes of vehicle, such as heavy-axle trucks, or certain classes of driver, such as habitual alcoholics? Would they be free to change the rates they charge without applying to the government for permission? And would the level of spending on maintenance be specified by government or left to the company's incentive to attract business? Only some of these questions are answered in the Adam Smith Institute books.

David Howell, minister of transport in the Thatcher government, contributes some moderately skeptical views in an introduction to the anthology of essays. "Once a road is built, governments will not let it 'fail,'" he writes. "So roads are inherently governmental. In France, for example, where companies provide and finance roads by tolls the state has had to intervene to support a private sector company whose motorway had insufficient traffic to finance its capital debts."

Providers of private roads, so long as they relied on direct user charges, would face unequal competition from the "free" roads financed through the gas tax and license fees. This inequality is economically wasteful, since it means that traffic that logically should take the private road will be diverted to inferior "free" routes. Gabriel Roth, a Washington, D.C., specialist in transport economics, suggests equalizing the competition by diverting some gas tax receipts to the private road suppliers, based on their recorded traffic counts—in a sort of analogy to an educational voucher system.

The technological means may soon be at hand to charge drivers directly for the use of roads through methods more flexible than tolls. The Port Authority of New York and New Jersey has studied electronic pricing systems in which automobiles would be equipped with devices carrying a unique electronic "signature" for each vehicle; sensors implanted in the roadway would monitor each car's use of roads or bridges and bill the owners periodically, much as telephone use is billed to callers today. The advantage of electronic metering is that it is a pricing system "which does not involve the use of coins, does not require vehicles to stop, does not require the delineation of rigid boundaries, and which could be applied simultaneously to new high capacity roads and to old congested ones." It would not, however, resolve the inequality of competition between public and private road systems, unless the public systems moved to replace their gasoline taxes with electronic fees. [EDITOR'S NOTE: *Hong Kong has announced plans to introduce a system of electronic road pricing for some of its congested roads. At first, six thousand government automobiles will participate; if the program works well, it will eventually be extended to all automobiles in the colony.*]

Showdown in Solano County

Dow vs. California: A Turning Point in the Environ-business Struggle by Christopher J. Duerksen (Conservation Foundation, 1982).

In 1977, after two years of struggling with California's regulators, the Dow Chemical Company abandoned plans to build a huge $500 million petrochemical complex near San Francisco. According to Christopher Duerksen, the case marked the end of the "halcyon days" of the environmental movement; never again would its values be accepted uncritically, without scrutiny of their effects on the economy and on employment. Duerksen, a lawyer with the Washington-based Conservation Foundation, directed its four-year project on how environmental laws affect plant siting decisions and how government agencies and companies can improve the way facilities are regulated and built.

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Dow unveiled plans for the facility in 1975. It was intended to process the relatively cheap and plentiful Alaskan oil that was then coming into production. By saving the $56 million a year that it had been costing Dow to ship such products as styrene and ethylene from its Texas plants to the West Coast, Dow hoped to cut costs and thus capture a bigger share of the West Coast market. The plant was to employ 1,000 laborers during construction and 800 permanent workers when it opened in 1982.

There were several compelling reasons for Dow to choose the particular site it did, in a sparsely populated but growing area between San Francisco and Sacramento. The site was one of the last port locations on the West Coast deep enough to handle large oil tankers. It was also near one of Dow's existing facilities, which meant that key personnel were close at hand. The county government, furthermore, avidly supported the plan, hoping to bring in jobs and property tax revenues. (Unemployment reached 9.4 percent in California during the 1974–76 recession.)

Dow advanced rapidly through the local regulatory process. The state required an environmental impact report separate from and stronger than the federal one, but the local authorities approved it in record time. By then, however, environmentalists, mostly from nearby Berkeley and San Francisco, had begun to organize against the project. The project adjoined a marsh that served as a principal feeding and wintering ground for about a million migratory birds on the Pacific Flyway. There were a number of other serious problems in the eyes of opponents, the author says, "but secondary growth—the new county residents and houses they would require, local government services, and downstream industries—that Dow might induce probably bothered the San Francisco-Berkeley contingent as much as anything." They filed suit, claiming (among other things) that the impact statement had not considered all alternative locations where the environmental damage might be less severe. The California law, unlike the federal one, requires that projects relocate in less sensitive areas unless there is some good reason not to. The suit also contended—correctly in the author's view—that Dow had not sought an amendment to the local land use plan required by state law.

Another concern was farmland preservation. The property was protected by an agricultural land preservation contract with the local government which Dow was seeking to have canceled. The state Department of Agriculture had no role in granting permits for the project, but one of its staffers involved in farmland preservation efforts flagged the case for the state attorney general's office, which began to prod other agencies. Before long several agencies that had previously signaled their approval showed signs of changing their minds and began asking for more information. "We had a running joke about almost having an underground government," a leader of the environmentalists told Duerksen, "because so many of our people were on state phone lines or knew state people. It really helped on the phone bills and getting [hold] of state people." According to Governor Jerry Brown's policy director, the lawyer assigned to the Dow case in the attorney general's office "was, behind the scenes, involved in the Sierra Club lawsuit . . . at least informally."

Governor Brown tried to speed up matters by scheduling consolidated hearings meant to resolve the remaining questions about the project. Dow wanted this hearing to be reserved for sworn testimony by experts, but the governor's policy director said it had to be open to the public. As the policy director told Duerksen: "It was every bit as zany and dramatic as you imagine. My first premonition of trouble came when I heard the sound of tom-toms coming from the corridor outside the hearing room." The Indian presence also included the chanting of a medicine man named Moose Camp. Another speaker proceeded to declare, as Duerksen puts it, "his friendship with the mockingbirds and blackbirds." Worse yet, from Dow's perspective, a state official ruled that the hearings' contents had to be incorporated as a supplement into the previously approved environmental impact report, which meant that all the issues raised at the hearing would have to be addressed.

Dow suffered an even more damaging setback not long thereafter from the autonomous regional air quality board responsible for enforcing local and state laws on factory emissions. The board turned down Dow's application for air pollution permits for the first plant it wanted to build on the site. The reason was

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not that the plant was not as clean as possible —Duerksen says everybody recognized that "the plant would be squeaky clean when compared with older styrene facilities in other states." Rather, it was that so long as the local air still fell short of federal standards—even for one day a year—it was illegal under the board's EPA-approved rules to allow any "significant" new pollution sources to be built. And anything that could be measured was "significant," under the air quality board's own interpretation. Dow claimed that the styrene plant's emissions would be undetectable at the plant's boundary line, but the board ruled that this made no difference: within the plant gates, both particulate and organic emissions would be about five times the detectable thresholds. Dow offered to clean up its other local plant so as to prevent overall pollution from rising, but that too was impermissible under the existing law.

Finally, in January 1977, Dow announced that it was abandoning the project. An executive said later: "With no positive results to show after spending two and a half years and $4.5 million to get four permits out of sixty-five, I had to cut my losses." The company sharply criticized the agencies and environmentalists for their allegedly obstructionist tactics. Dow had built up a reputation over the years as an environmentally conscious firm, Duerksen says, which made the impact of its public complaints that much greater. At any rate, the reaction in the state was swift. Business and labor leaders reacted with outrage, and the state government and the environmentalists were put on the defensive. In Washington the Environmental Protection Agency, which had already come under great pressure to allow at least some industrial growth in "noncompliance" areas, soon agreed to let companies build new plants if they found ways of achieving offsetting reductions in existing facilities.

Duerksen believes the Dow dispute holds important lessons, if only because it is bound to be repeated in the future. He opposes weakening environmental standards themselves, but favors "quiet" reforms to streamline the permit process, such as state "industrial escort services" that would help companies find out which permits they need from which agencies at what times. He says states might also offer to help industry avoid picking sensitive sites that are likely to arouse opposition.

He also says industry should pay more attention to its environmental impact in general, and, more specifically, should make its project planning more open to the public, involve environmental specialists at an earlier stage in the process, and vest clear authority in a single project manager. Mediation of environmental disputes, he says, may provide a more promising framework for eventual cooperation than judicial review.

Untamed Regulators of the North

Regulatory Reform in Canada by W. T. Stanbury and Fred Thompson (Institute for Research on Public Policy, Montreal, 1982), 139 pp.

Regulatory reform has been studied extensively in Canada, but little has come of it, according to W. T. Stanbury of the University of British Columbia and Fred Thompson of Columbia University in New York. Between 1979 and 1981 the Economic Council of Canada published some sixty studies on regulatory subjects ranging from taxicabs to fisheries. Although the Ottawa government had itself commissioned many of the reports, it greeted them with little enthusiasm, and there has been "almost no change in federal or provincial regulatory regimes" attributable to the reform efforts, Stanbury and Thompson say. Both authors were formerly with the Economic Council, which is itself a quasi-independent arm of the Ottawa government.

In the Canadian system, the decisions of regulatory agencies can be appealed to the full cabinet. (There have been unsuccessful proposals to replace this system with one of periodic policy directives from the cabinet, or at least to open the cabinet review process to public scrutiny.) The Treasury Board, which oversees Canadian regulatory reform, adopted a directive in 1978 requiring socioeconomic impact analyses for all major new regulations in the areas of health, safety, and "fairness." ("In the first three years of operation," however, "only three SEIAs were published. . . .") Parliament considered a bill in 1979 to require environmental impact analyses as well, but did not pass it. The Treasury Board created an Office of the Co-ordinator for Regulatory Reform in

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1980, but according to the authors it has not pushed the agencies very hard. "If a strong minister wishes to do nothing to reform his regulatory domain, he will get no 'flak' from the OCRR and the president of the Treasury Board."

As for particular industries, the authors say, the few steps toward liberalization that have been taken have been reluctant, compelled largely by technological change and by competitive pressures south of the border. Throughout the postwar years "Canada regulated airlines even more stringently than did the United States," and despite some loosening of control starting in the mid-1970s there has been no wholesale deregulation. Government-owned Air Canada has been subjected to the same laws as its private competitors, and the private carrier CP Air has been allowed to compete with Air Canada on transcontinental routes. Discount fares and charter flights have been liberalized somewhat, but strict entry controls and required rate filing persist. Moreover, the minister of transport offered a proposal in August 1981 that would have re-regulated the industry intensively. Although a parliamentary committee rejected the scheme, it also rejected full deregulation.

Banking laws were amended in 1967 and 1980, and many of the changes were liberalizations; for example, Canadians may now start a new bank without an act of Parliament and may convert other kinds of financial organizations into banks. "The rules governing foreign banks have been greatly relaxed"; on the other hand, such banks must now keep domestic reserves, and all of them combined are limited to an aggregate of 8 percent of total banking assets—in one of a very large number of Canadian laws promoting "sovereignty, cultural identity, and national unity objectives."

Telecommunications regulation in Canada, as in the United States, has been enmeshed in running controversies over "terminal attachment" and "system interconnection," or, put more simply, over what sort of equipment consumers and independent companies can attach to phone company lines in order to enhance or bypass phone company service. In this country, the 1968 *Carterfone* decision established that consumers had wide rights to hook up their own equipment, but "it was not until 1980 that anything comparable was possible in Canada." In 1979 and 1980, the Canadian Radio and Telecommunications Commission handed down rulings liberalizing system interconnections.

More typical of the general interventionist drift, the authors say, was the National Energy Program announced in 1980, perhaps the most comprehensive attempt at government planning since World War II. It includes great expansions in public ownership, regulation of energy companies, subsidies, and so forth.

There has been some talk of regulatory reform at the provincial level. The Ontario government proposed a vague "deregulation" program in early 1978, and followed it up with a concrete proposal to eliminate forty-six agencies of hundreds reviewed. A provincial committee set up to examine regulation of the professions in Ontario recommended in 1980 that the province let professionals incorporate, allow lawyers to advertise fees in the print media, and provide that all future claims for licensure be reviewed by cabinet committee, among other things. As of April 1982 the provincial government had not acted on these suggestions.

Legitimacy through Bargaining?

"Negotiating Regulations: A Cure for Malaise" by Philip J. Harter, in *Georgetown Law Journal*, volume 71, no. 1 (October 1982), pp. 1-118.

The Administrative Procedure Act of 1946 imposes relatively few requirements on agency rulemaking. An agency that wants to develop a rule need only consult with the public, draft a proposal, receive comments, and publish the rule with a brief explanation.

According to Washington attorney Philip Harter, this minimal set of procedures is satisfactory for regulations that enjoy clear "political legitimacy," either because the public trusts the neutral expertise of the agency staff or because there is a broad public consensus on what the agency is supposed to regulate and how. But with the enormous growth in regulatory activity since the APA was passed, Harter says, agencies have come to promulgate more and more regulations that have no such legitimacy —either because the factual predicates of the rules are enormously complex and controversial or because there is no consensus on the

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agency's mission. In an effort to restore political legitimacy to their regulatory actions, the agencies were freed to use a new set of procedures, the so-called hybrid rulemaking process, which is now the dominant way of developing regulations.

According to Harter, the political theory that underlies the hybrid rulemaking process holds that an agency should follow procedures designed to ensure that it reaches a rational result based on the material in its record and that all parties should have a right to present the agency with facts and arguments for inclusion in that record. Under this theory, participants try to influence the agency's range of discretion by controlling the material that gets into the rulemaking record.

The problem with this theory, Harter says, is that most of the new sort of regulatory questions have no single, rational, value-free solution: they call for the kind of political choice among competing values that formerly took place in, and gained legitimacy from, bargaining processes in representative legislative bodies. Lacking the legitimacy that comes from elections, and having lost the old legitimacy that came from "rational" handling of objective problems, the current rulemaking process manages to dissatisfy virtually all its participants. This dissatisfaction is what has become known as the "malaise of administrative law."

One often-discussed way to imitate the legislative process would be to have agencies develop regulations by negotiation, as frequently occurs in Western Europe. Harter warns against what he calls the "hot tub" theory of negotiation—the notion that parties will reach an amicable agreement simply because they agree to attend negotiation sessions that are labeled nonadversarial. He observes that negotiating is only a way of channeling conflict, not a substitute for conflict, and that it will not work in all situations. Nonetheless, he says, there are conditions under which negotiation may be suitable.

One way to discover some of these conditions is to examine instances where policy is negotiated now. State and local governments, for example, use a great many technical "consensus standards" as the basis for such regulations as electrical and building codes. Very few original regulations are developed in this way at the federal level, but negotiation does play an important role at later stages: many lawsuits challenging rules are settled by agreement of the parties, as are consent decrees in suits against the government and, increasingly, environmental controversies.

Some fairly uniform principles can be drawn from the various instances, Harter says. For one thing, the number of interests represented in the negotiations at any one time must not exceed fifteen or so. The key interests must be homogeneous enough that particular spokesmen can represent their points of view adequately. The issues to be resolved must be mature and ripe for decision, and their resolution must not require any party to compromise a fundamental "article of faith." The outcome of the proceeding should truly be in doubt; the various parties should possess "countervailing power" to check each other's actions, so that no one interest can dominate. Some decision or other should be inevitable within the relatively near future, so that no one can hope to gain by repeated delay. The agency itself must be represented in the discussions by a senior staffer; even more crucial, it must be willing to abide by the result of the negotiations.

Harter proposes a plan under which an independent third party, chosen by the agency, would be empowered to do two things: first, decide which interests were heavily enough affected to be represented at the table and, second, mediate and manage negotiations. The negotiating group could jointly conduct any factual research that might be needed to help develop a consensus on a proposed rule—consensus meaning, in this context, that each overall interest (which would not necessarily include each subgroup) would concur in the final result. Thus none of the interests would have to fear that the others would combine against it. If the group succeeded in agreeing on a compromise plan, the relevant agency would then, unless it had some good reason not to do so, publish the plan as a notice of proposed rulemaking. At this stage there should be few surprises, Harter says, because the interested parties would perforce be familiar with the details of the rule and its development. [EDITOR'S NOTE: *The Administrative Conference of the United States has adopted a recommendation based on this proposal and several agencies are experimenting with it.*]

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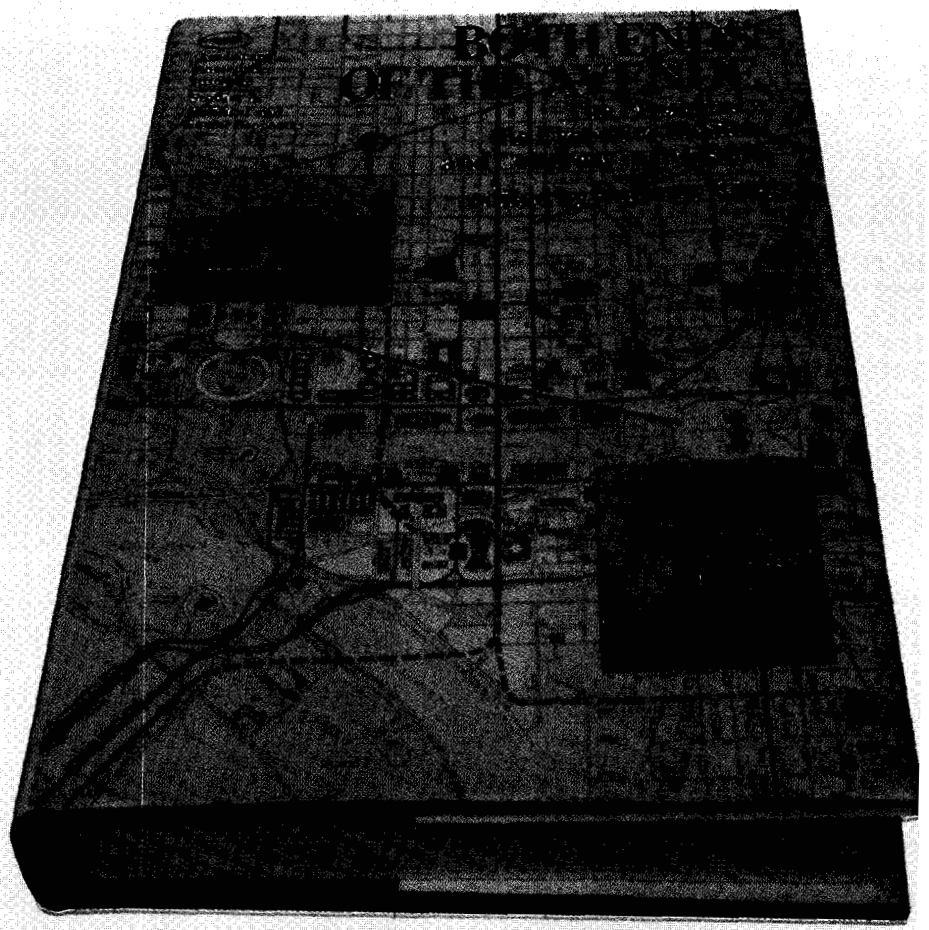

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